



Restoring Trust in the Financial Markets: Time to Think Sustainably

10th International Sustainability Leadership Symposium 2009
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Preface

In 2009, *The Sustainability Forum Zürich (TSF)* celebrated its 10th anniversary. The association was founded in 1999 to promote sustainable business in the dynamics of globalisation. Addressing financial market topics of international relevance, our dialogues regularly attract opinion leaders, experts and practitioners of the highest ranks. Over the last decade, TSF became increasingly recognised as a leading think-tank and discussion platform for sustainability issues relevant to the financial markets. Our International Sustainability Leadership Symposia – this year’s event is the tenth in a row – are the flagship events of our association.

The topic “Restoring Trust in the Financial Markets” might be astonishing to some. Let us explain why we think it is so relevant within the debate about sustainability: Only a week after our previous symposium, dramatic events in the USA turned the already precarious situation on the financial markets into a huge crisis affecting the whole world. Not only weaker players but also some of the strongest ones were badly hit. The pre-crisis conviction that the financial institutions were virtually risk-proof gave way to the realisation that the markets had become too complex to control, and it appeared that through ill-designed incentives and excessive risk taking the financial industry itself constituted the core of the problem. The result was the collapse of the main pre-requisite for doing business: trust. The financial industry, which is expected to manage its customers’ assets and risks in a sustainable manner, is accused by its key stakeholders of being led astray by its desire for maximum short-term profit.

Therefore, TSF decided to make the question of restoring trust the theme of its tenth annual symposium. How can mutual trust among the players in the financial sector be regained, and how can the customers’ faith in the reliability of the financial system be re-established? How can the financial system demonstrate that it is again able to play its role as facilitator of economic activities? These and other key questions have been addressed by the 170 attendees during the 10th International Sustainability Leadership Symposium 2009.

This report contains a summary of the presentations and lively debates. We would like to thank the speakers, moderators and participants for entering into a constructive and candid dialogue about the lessons learnt. We hope the symposium was useful as a creative break that will help the financial market to emerge from the crisis stronger than before.



Peter Forstmoser, outgoing Chairman
The Sustainability Forum Zürich



Thomas Streiff, CEO
The Sustainability Forum Zürich



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Summary and Conclusions

The 10th International Sustainability Leadership Symposium, which marked the 10th anniversary of *The Sustainability Forum Zürich (TSF)*, addressed one of the most pressing questions arising in the wake of the financial crisis: how can trust in the financial markets be restored and, in line with the association's focus over the past decade, how can a sustainable financial market be created?

There have always been financial crises and there will be more in the future. But the magnitude of the present one seems to be unrivalled. So rather than attempting to draw up prescriptions for preventing future depressions, the symposium asked what could be learnt from past crises, considered as "creative breaks", in order to better contain the ones that will occur in the future.

There was broad consensus that the financial sector does not require more regulation but better regulation. But what is good regulation? Should legislation analogous to the environmental polluter pays principle be applied to the financial sector, forcing companies distributing "toxic" products to pay for the damage they cause? What reforms are required? Many of the speakers stressed that fast and reactive adaptation measures would be contra-productive. Good regulation should increase transparency, which again is an important ingredient for sound competition.

Diversity was another issue which was addressed by several speakers and tackled in the discussions. Diversity of opinions, at Board of Directors (BoD), executive management and everyday working levels should be regarded as an asset rather than as the obstacle it is often seen to be. How to foster diversity and harness the "wisdom of crowds" remains a challenge, though these are vital elements of a sound and sustainable culture.

To restore trust in the financial markets, the role of credit rating agencies has to be reconsidered. Much discussion centred on the conflict of interest arising because the rated companies pay the rating agencies and depend heavily for their success on the ratings given. Inadequate fulfilment of fiduciary duties by intermediaries in the financial markets was also addressed. The financial sector was criticised for neglecting its responsibility, in some cases deliberately. Rebuilding trust in the financial sector requires sector related consciousness, which seems still to be rather weak. The financial industry can manifest its sense of responsibility in the way it develops and markets its products and services, and by striving to understand its clients' needs.

Is it time to think sustainably? What does sustainability mean for the financial services industry? If the common denominators of financial service provision and capital management are people and trust, a sustainable financial industry builds on a healthy culture, which is defined by leadership, governance, integrity and "intelligent" incentive/disincentive schemes, taking into consideration behaviour and performance in a meaningful time frame.

The symposium closed with the question of whether Switzerland can be a hub of sustainable finance. Viewed systemically, the country is well positioned to take on the role, and should endeavour to remain so. Regarding products, the symposium called on asset owners to assume a stronger leadership role and demand more sustainable products and services.

Symposium Programme

Thursday, 10 September 2009

Time	Speakers	Topic
09:00	Peter Forstmoser , President, The Sustainability Forum Zürich	Welcome Address
09:10	Kaspar Villiger , former Swiss Federal Councillor & Chairman of the Board of Directors, UBSs	10th Anniversary Speech: 10 years of sustainability in Zurich? Has the ground been paved?
09:30	James Surowiecki , author of "The Wisdom of Crowds" & financial columnist at The New Yorker	Herd behaviour vs. collective intelligence How we get our collective judgement right
11:00	Kai-Uwe Schanz , Chairman & Principal Partner, Dr. Schanz, Alms & Company; in dialogue with Markus Nöthiger , Partner, PricewaterhouseCoopers	Setting the scene: Introduction to the topic & major findings from the discussion paper
12:35	Short inputs & panel discussion Peter Fanconi , Head Private Banking, Vontobel Group Paul Frentrop , Head of Corporate Governance, APG Asset Management Paul Lee , Director-UK, Americas, Africa & Australasia, Hermes Equity Ownership Services	Owners and gamblers – the mutuality of the financial and the real economy
16:30	Parallel Breakout Sessions Ivo Knoepfel , onValues Paul Frentrop , APG Asset Management Doris M. Schönemann , AHV Raj Thamotheram , AXA Investment Managers David N. Bresch , Swiss Re Alexander Lipton , Bank of America Merrill Lynch Paolo Vanini , Zurich Cantonal Bank Jermyn P. Brooks , Transparency International Sean J. Egan , Egan-Jones Ratings Company Alexander Ohl , Union Investment David P. Frick , Nestlé Gregor Greber , ZCapital Margit Osterloh , University of Zurich	A1: Responsible investors: The role of asset owners in restoring trust A2: Risk modelling, systemic risk and complexity: What are the limits to diversification? A3: Risk management, ratings and infor- mation asymmetries: Setting the right incentives for systemic stability A4: Corporate governance and sharehol- der engagement: A valuable investment in trust towards financial sector firms?
16:30	Thomas F. Cooley , Dean, Stern School of Business, New York University	Financial Instability: Should the 'Polluter' Pay?
17:00	Sean J. Egan , founding partner & managing director, Egan-Jones Ratings Company	Ratings as a Top Sustainability Issue. The Role of Inflated Ratings in the Crisis

Friday, 11 September 2009

Time	Speakers	Topic
09:00	Bill Emmott , former Chief Editor, The Economist	The crisis – a creative break or just a redistribution of power? A global-geographical perspective on the world economy, capital flows and the new rules of the game
	David Blood , Senior Partner, Generation Investment Management	Corporate culture in the financial services industry
16:30	Parallel Breakout Sessions	
	Erik Breen , Robeco Marco Curti , Zurich Cantonal Bank Michael Imholz , The Boston Consulting Group	B1: Incentive structures in HR: how to balance taming and promoting the best and the brightest?
	Ivor Godfrey-Davies , HSBC Hanns Michael Hölz , Deutsche Bank	B2: Trust and reputation: The corporate dimension
	Ralf Frank , DVFA Daniel Mahler , A.T. Kearney Burkhard P. Varnholt , Bank Sarasin Paul Clements-Hunt , UNEP Finance Initiative	B3: Sustainable investments: a catalyst of trust and stability in financial markets?
	German Egloff , Baloise Holding Nick Lin-Hi , University of Mannheim Heinrich Wiemer , Capital Market Strategies	B4: Corporate values: are traditional virtues in conflict with market incentives?
12:00	Panel Discussion	After the crisis: Can Switzerland become a hub of sustainable finance?
	Peter Gomez , Chairman, SIX Group; Dean, Executive School of Management, Technology & Law, University St. Gallen	
	Martin Maurer , General Secretary of the Association of Foreign Banks in Switzerland	
	Zeno Staub , Head, Asset Management, Bank Vontobel Group	
12:50	Thomas Streiff , CEO, The Sustainability Forum Zürich (TSF)	Closing

Discussion Paper: Core Theses

During the expert interviews a wide variety of different perspectives emerged. Consensus views were the exception rather than the rule. Nevertheless, it is possible to distil a number of theses which reflect the “spirit” of the interviews.

What went wrong?

1. Risk has been grossly mispriced by markets. In the absence of effective risk management tools, corporate decision-makers and regulators were lured into a false sense of security by the promise of securitisation and globalisation. Risks were supposed to be effectively dispersed and inflationary pressures tamed. This led to a monetary policy of cheap credit and excessive leverage of company and household balance-sheets.
2. Corporate business models were driven into an area of excess not just by ill-understood financial innovation but also by ill-designed compensation and incentive structures. On that basis, the macro-economic imbalances underlying the crisis – insufficient savings and excessive spending in the US – developed into a major dislocation of financial markets and real economies.
3. The way most boards of directors operate makes it difficult for dissenting voices to make themselves heard. Frequently, boards are too close to the CEO, not truly independent, reluctant to appoint dissenting newcomers and insufficiently familiar with enterprise risk management, including macro-economic exposures, and overly reliant on the role of the rating agencies as quasi regulators. In short, appropriate “rules of the game” are either not in place or not adhered to.
4. There was too little public intervention in certain aspects of corporate governance such as compensation schemes and risk taking. Frequently, regulators were not up to the challenge, lacking the necessary financial literacy and a truly global approach, matching the business realities of a globalised economy.
5. The financial crisis exposed serious flaws of corporate risk management. Stress testing was not properly implemented, particularly in banking. More often than not, quantitative models were allowed to supersede managerial judgment, experience and intuition.
6. In a large number of financial organisations traditional values such as sustainable and prudent behaviour were eroded by pecuniary incentives which encouraged short-termist and excessively risky behaviour.

The future of finance: Towards a sustainable paradigm

7. Transparency and disclosure must be enhanced markedly in order to render financial markets less susceptible to shocks and dislocations. Excessive risk taking, e.g. exacerbated by securitisations that permitted originators to lay off 100% of their economic risk on the financial markets, must be constrained by appropriate regulations. These measures, however, are neither expected nor intended to lead to “fail-proof” financial markets as occasional set-backs and dislocations are a key feature of any markets-based economic system.
8. Governments should refrain from intervening with corporate business models and strategies as the downside of policy mistakes is significant. Customers and investors are expected to effectively push for more long-term oriented behaviour by management. Managers themselves (e.g. their personal wealth) have suffered during the crisis which is likely to promote more responsible and sustainable behaviour.
9. In corporate governance, however, there seems to be a strong case for increased public intervention, not least due to the public good character of corporate governance. Priority areas in this regard are incentive structures and ways of promoting dissenting voices in boards of directors in order to make boards of directors “less clubby and cosy”. Such efforts could also be helped by a bigger role of third-party shareholder representatives advocating a longer-term perspective as well as new ways of selecting board members.
10. The crisis has revealed major public policy flaws. The domestic character and focus of regulation in times of globally operating companies and integrated economies has proven to be grossly inadequate. Global coordination and consistency need to be stepped up significantly. In addition, the notion of systemic risk, i.e. the risk posed by individual organisations to the financial system as a whole, needs to be introduced into global financial services regulation. And, last but not least, central banks should explicitly recognise asset inflation in order to pre-empt dangerous (credit) bubbles going forward.

Discussion Paper: What Went Wrong?

Any analysis of the current economic downturn and financial crisis has to commence by answering a seemingly simple question: What went wrong? In hindsight, which aspects of the financial market mechanism, business models, corporate governance structures and public policy frameworks were most severely flawed? The following section endeavours to address these questions in order to lay the foundation for specific corporate and public policy recommendations aimed at introducing more sustainability into the world of finance.

Financial markets: Lured into a false sense of security

Regarding the role of financial markets *Bill Emmott* summarises as follows: "We have seen a gross mispricing of risk, based on markets' significant complacency about risk." He feels that both market participants and regulators were "fooled" by securitisation and its promise to disperse risk. *George 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. As a consequence, we have seen reckless behaviour, very poor underwriting of risk, and perverse economic incentives in many cases." In addition, as *Peter Voser* points out, 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."

Emmott believes that globalisation has created "a false sense of security" as it was supposed to have removed the issue of inflation from the agenda. This encouraged central bankers to pursue a policy of cheap credit which seemed to be the right thing to do after the dotcom crash and the shock of 9/11. *Klaus Wellershoff* agrees: "The current crisis is the result of collective exuberance and exaggeration. 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.

Ernst Fehr feels that "regulatory failures also contributed to the current crisis". As public regulation usually reflects the lessons from the latest crisis problems occur as soon as innovation accelerates. "Regulators were unable to keep pace with the enormous acceleration of financial innovation over the last ten years", says *Fehr*.

Emmott agrees and 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”, *Emmott* concludes. 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*. He thinks that, in hindsight, excessive risk taking by banks was clearly exacerbated by the absence of explicit and binding leverage ratios in many cases. *Voser* also believes that gearing ratios outside of traditional commercial lending were too high.

Patrick M. Liedtke offers a different view on the role of markets and regulators. He wonders how sustainable markets can be. “Crises and crashes are normal situations in markets. From time to time, markets need shake-outs, a sort of ‘creative destruction’ in the sense of Schumpeter¹.” *Liedtke’s* biggest concern in this context is the collateral damage of such shake-outs “on the things that actually do work”.

All experts agree that we have seen crises of similar severity before. A distinctive feature of the current crisis is its global scope. “Unprecedented transmission mechanisms have been at work here, enabled by deregulation and globalisation”, says *Wellershoff*. There is also a general consensus that herd behaviour is no particular characteristic of the current crisis. “Herding is part of human nature. It cannot be eradicated”, says *Fehr*. Both *Emmott* and *Wellershoff* believe that herd behaviour, a traditional behavioural pattern in boom and bust phases, was exacerbated by open, globally integrated markets. “This is new”, they say. In general, the role of herding should not be exaggerated. “It may have accelerated the crisis but has nothing to do with the root causes”, *Liedtke* agrees.

Most interviewees were sceptical as to whether there is a long-term responsibility of shareholders for the shares they own. *Fehr* points out that most shareholders’ financial literacy is limited. “The vast majority of them are just interested in short-term monetary returns.” *Liedtke* concurs and believes that markets are determined by trading-minded, not long-term and stable shareholders. In his view, short-term oriented shareholders have to accept a sizeable portion of the blame for the crisis as they all too often encouraged management to aggressively improve capital efficiency through debt finance as well as to return “excess” capital to them – capital which turned out to be painfully missing when the crisis started to bite.



Stine Bosse
CEO, TrygVesta



Bill Emmott
Former Chief Editor, *The Economist*

¹ The Austrian economist Joseph Schumpeter popularised and used the term to describe the process of transformation that accompanies radical innovation.

Discussion Paper: What Went Wrong?

Business models: In reckless pursuit of opportunity

In respect of our second area of analysis, corporate business models and strategies, *Fehr* points to the crucial role of corporate incentive schemes: “They were ill-designed as excessive risk taking was rewarded.” At the end of the day, their conceptual flaws fuelled the mispricing of risk – the root cause of the crisis. *Stansfield* does not agree. In his view, incentive schemes were certainly a contributing factor to the crisis but not a principal driver. “Excessive leverage, I think, 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 due to commoditisation. To address this long-standing issue, he says, banks did accelerate financial innovation, took on increased risk and, ultimately, deviated from their traditional business model. “Poor incentive structures have facilitated the crisis, but did not trigger it”, he concludes. *Wellershoff*, however, offers a different view: “Banks have certainly neglected the traditional virtue of prudence when taking on excessive credit risk. However, I believe that the root cause of the crisis is the enormous leverage of the US economy and a notorious lack of savings on the other side of the pond.” *Liedtke* is also 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.

Talking about corporate structures and strategies, *Stansfield* believes that complexity, rather than size has proven to be problematic. “There are many organisations with huge balance-sheets that have remained focused and sailed relatively smoothly through the crisis.” The inability of traditional risk models such as Value-at-Risk to anticipate extreme scenarios has further added to the risks associated with organisational complexity and bold strategic shifts. “Such models must never substitute for managerial judgment.”

Corporate governance: Skills deficits compounded by cosiness

Emmott identifies two major flaws in corporate governance that have contributed to the crisis. First, formal corporate value systems and compensation structures have proven to be largely incompatible. "Efforts to implement values such as sustainable and prudent behaviour were foiled by pecuniary incentives which encouraged short-termist and excessively risky behaviour." Second, huge information deficits due to enormous complexity and insufficient disclosure impaired board members' ability to effectively perform their role. In respect of values, *Liedtke* adopts a different view: "I think that the current crisis was not caused by a spectacular break-down in values. We have seen nothing comparable with, let's say, the World Wars of the 20th century. So while the values did not change much, the discrepancies between the values and the regulatory and compensatory incentives came to a head."

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: "That needs to change. This applies not only to the financial sector, but to business in general."

Wellershoff points to one specific skills deficit among board members of financial services companies: A lack of expertise on macro (-economic) risks, risks that were grossly ignored by most quantitative models.

Stansfield believes that "in certain cases, boards were simply too close to their CEOs and there was no effective system of checks and balances". In such environments, dissenting voices were not allowed to make themselves heard. *Fehr* agrees. In his view, the way board members are selected is flawed as the underlying process is largely driven by existing board members. "This makes it difficult to add dissenting characters to the board." *Stansfield* also considers the concept of independent directors as being ill-defined in certain cases: "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. The importance of a relevant industry background has been somewhat neglected," *Liedtke* concurs. He stresses the importance of a decent level of "insider know-how" for any board member to perform his role. "Insider know-how, understood as familiarity with the business, should not be demonised as incompatible with the status of an independent director."



Ernst Fehr
Professor, University of Zurich



Patrick M. Liedtke
Secretary General, Managing Director,
The Geneva Association

Discussion Paper: What Went Wrong?

Public policy: Lack of expertise and global approach

Emmott views insufficient disclosure requirements as a major policy flaw contributing to the crisis. "For example, off balance-sheet vehicles which brought large institutions to the verge of collapse were simply not recognised." He also reiterates a point made earlier: the lacking alignment of regulatory standards and capabilities with the pace of financial innovation and complexity. More specifically, *Emmott* believes that monetary authorities were wrong in ignoring the phenomenon of asset inflation (e.g. soaring property and share prices) when defining monetary policy. This failure has prevented central banks from "stopping the party" at an early stage. Instead, they continued flooding markets with cheap money, encouraging households and corporations to excessively leverage their balance sheets.

Fehr believes that there was too little public intervention in corporate governance. He makes the economic case for this view, based on the public good / free ride problem associated with corporate governance. "Why should an individual shareholder bear the cost of major activities as all others are set to benefit, too?" Such circumstances suggest a public policy and regulatory response.

Liedtke points to two additional regulatory deficits that have contributed to the crisis. "Regulations were largely defined and implemented in a domestic context, whilst the world economy had reached an unprecedented degree of globalisation and integration." He feels that this mismatch has played a major role in causing a truly global crisis and dislocation. He also believes that regulators failed to take properly into account systemic risk, i.e. the risk a single, large and complex organisation can pose to the financial system as a whole. *Stansfield* agrees: "Institutions have become global. Regulation which is still largely of national character needs to be adapted." While he believes that regulatory structures need to be re-examined and adapted, he also feels that one aspect of regulatory reform is getting far too little attention: ensuring that these regulatory bodies are sufficiently funded so they can attract high quality professionals that have the training, industry experience and time to fully appreciate and analyse the complexity and potential implications of the issues at hand.

Emmott, *Liedtke* and *Stansfield* all emphasise the role of rating agencies as "quasi regulators". They agree that rating agencies gave their blessing to highly leveraged business models. At the same time they were unable to fully penetrate the intricacies of innovative financial products and, more seriously, were often mired in conflicts of interests as rating complex structured credit products was a highly profitable area of business.

The future of finance

Towards a sustainable paradigm

How can stakeholders' trust in the viability of the financial sector be restored? Which measures need to be taken to put global finance on a more sustainable basis? In order to answer these questions we follow the same approach taken for the retrospective analysis and will look at the market framework, corporate strategies and business models, corporate governance and the public policy framework.

Financial markets: Self-regulating forces need to be complemented by public intervention

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. 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 transactions were a major part of the problem as their overall extent and interrelatedness were neither disclosed nor understood." *Emmott* is convinced that transparency and disclosure are more relevant to preventing excesses than increased capital requirements.

Fehr disagrees: "Excessive risk taking must be constrained." He points to the example of the pharmaceutical industry where entrepreneurial freedom is curtailed due to human health considerations – without choking the market mechanism or stifling innovation. *Voser* also believes that "it is imperative to overhaul the balance sheet regulation of all financial institutions." *Stine Bosse* agrees: "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."²

Stansfield sees a 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. *Wellershoff* concurs: "The division of labour between risk originators and absorbers has been driven too far and needs to be revisited." In this area the self-regulation market mechanism should not be relied upon.

On the topic of accounting standards *Voser* expresses the hope that the crisis will not slow down the process of convergence between US Generally Accepted Accounting Principles (US-GAAP) and International Financial Reporting Standards (IFRS). *Liedtke* 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. *Emmott*, however, maintains that "mark-to-market" remains fundamentally right as it provides investors with a true and fair view of a company's state. *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. He also questions, from a longer-term perspective, the wisdom of exerting political pressure on accounting setters.



George Stansfield
Executive Vice President,
Group General Counsel, AXA



Peter Voser
Group CEO, Shell

² Stine Bosse has chosen to limit her comments to "The future of finance".

Discussion Paper: The future of finance

Towards a sustainable paradigm

Wellershoff believes that, in general, the market mechanism will be most effective in implementing the lessons from the crisis. "Senior executives and professionals in the most heavily affected financial institutions have suffered huge losses in personal wealth. They will think twice before embarking on reckless leverage again. In many of the affected companies top management was required to hold company stock equivalent to a multitude of after tax salaries. If the share price drops by 80% or more managers have lost most of their life-time savings."

In the context of the future functioning of markets *Liedtke* raises a fundamental question: "Should we really aim for fail-proof systems?" He mentions road traffic as an example: "If you impose a speed limit of 5 km/h there would be no fatal accidents any more. However, road traffic would collapse." Regulators face the challenge of setting "speed limits" which strike an appropriate balance between the number of "accidents" and the performance of the overall system, i.e. financial markets. He also calls on regulators to act gradually and incrementally when changing markets: "Overreactions can jeopardise the long-term sustainability of new frameworks."

Corporate business models: No need for public intervention

Voser makes a very clear point: "As a businessman I still have 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. "There were serious mistakes in the financial sector, but the crisis is not a sweeping indictment of market capitalism", he concludes.

Despite her belief that new and better regulations are needed *Bosse* warns that the risk of overregulation needs to be carefully managed: "Excessive regulation will reduce innovation and motivation for growth and this could in the longer term work against an effective asset allocation and market expansion for the financial markets."

Wellershoff believes 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 also expects investors to adjust their return requirements to more reasonable and sustainable levels. "We will see an end to the 'drunkenness' of recent years and a return to more long-term oriented behavioural patterns." *Wellershoff* is adamant that the banks have not caused the current crisis. The most relevant contributor, in his view, is the excessive level of leverage of the US economy, largely due to insufficient savings. He, therefore, foresees no whole-sale changes to the banking industry's business models, but rather a more prudent approach to taking on credit-related exposures.

Liedtke also believes that markets and their sanctions are the most effective regulator of business models. "Compensation schemes will be redesigned so as to ensure that intelligent people stop doing stupid things based on wrong incentives." 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." *Voser* agrees: "Let's keep in mind that we are living in the real world and that boards cannot just hide behind formulas and model results, but must exercise judgment at all times." He also advocates remuneration systems that promote "enterprise first" behaviour instead of "me first" behaviour. These systems should be based on a balanced set of performance criteria that judge both the long-term and short-term performance of companies. *Bosse* advocates improved transparency of how companies are managed and their managers' compensation packages are linked to performance. "This helps ensure a balanced and sustainable reputation management and also functions as an internal security valve, which takes out any steam before excesses take the company's existence at risk."

Liedtke feels that the insurance industry with its long-standing familiarity with scenarios and a good understanding of model limitations can provide guidance to other financial services segments. *Stansfield* agrees: "Solutions have to be found for modelling and risk management systems which provide for stress testing and do not allow for quantitative models to supersede managerial judgment, experience and intuition."

Liedtke further expresses concern about current government interference in corporate restructuring: "One key lesson to be learned from the crisis is that 'too big to fail' is a highly problematic notion. Policymakers, especially in the US, seem to ignore this learning as they are instrumental in building even bigger financial behemoths."

Fehr is also sceptical of too intrusive and heavy-handed regulations in the area of corporate business models. He considers curtailing the size and complexity of companies a highly severe regulatory intervention with uncertain effects. "With globalisation, companies tend to grow larger and more complex and regulators should take account of this development", he points out.

Emmott believes that there is no need for regulation concerning future business models and corporate strategies in finance. "We are witnessing a 'back-to-basics' movement, with simplification combined with enhanced transparency and disclosure being the name of the game. This development is largely driven by shareholders and customers, not by governments." He also believes that, going forward, corporate decision-makers won't be fooled again that easily by the promises of cheap credit and limitless global opportunities.



Klaus Wellershoff
Member of the Board of Directors,
Schindler Holding

Discussion Paper: The future of finance

Towards a sustainable paradigm

Corporate governance: Severe flaws call for public intervention

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 as the benefits would accrue to all shareholders – irrespective of their individual efforts and respective expenses incurred. He sees a particular need for action in the area of compensation. “Flawed incentive structures have fuelled corporate risk taking and contributed heavily to the depth and breadth of the crisis”, says *Fehr*. He also calls for a strengthening of the rights of minority shareholders, another area where he sees a case for regulatory intervention in corporate governance. Even though he does not believe that compensation structures were a major contributor to the crisis, *Stansfield* calls for more long-term oriented schemes, with more weight given to equity compensation.

Emmott is convinced that incentive structures will change, not only in light of heightened political and regulatory pressure but also as a consequence of increasing shareholder sensitivities in this area. But he also cautions: “Don’t be naive about long-term reforms to incentive and bonus schemes: The war for talent will resume soon.”

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. In this context, *Fehr* calls for a bigger role of third-party shareholder representatives in order to more effectively bring long-term considerations to the board’s attention. He also advocates new ways of selecting board members, curtailing the currently dominant role of existing ones.

Wellershoff believes that more macro-economic risk expertise should be represented on boards of directors, an area where current skills sets have proven grossly inadequate. In addition, he suggests strengthening the role of ‘social balance-sheets’ as a complement to financial balance-sheets in order to “limit drunkenness and dampen growth euphoria”. On that basis, non-financial values and measures could be made more transparent, consistent and meaningful. In general, he believes that “corporate culture matters more to the success or failure of an organisation than legal structures. For example, a responsible meritocracy must be more than a lip service but a lived cornerstone of corporate culture.”

Voser highlights the crucial importance of corporate social responsibility which must be at the core of any company’s value system, including the financial sector. “The financial sector was never meant to be completely divorced from individual clients or the real economy. Banking is rooted in the trust society awards to them.”

Liedtke warns against establishing a legalistic compliance culture supplanting individual values: “Not everything that is done according to the rules is necessarily right.” Common sense should prevail, not just on the executive floor but also on the level of corporate specialists and experts.

Stansfield puts forward another 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 which already has an exceedingly full agenda of responsibilities and considerable demands on its time

Public policy: Taking into account systemic risk and the reality of global markets

In *Fehr's* view rebuilding trust in the financial markets is both a systemic-public and corporate-individual challenge. “As trust in the financial system as a whole can be regarded as a public good, policymakers and regulators need to play a role in restoring it.” The crisis has demonstrated the crippling effects of a wholesale erosion of trust, e.g. the virtual collapse of the interbank market in autumn 2008, and the need for the public sector to step in and avoid the worst, says *Fehr*. But he also acknowledges that “rebuilding trust starts at the individual level”. The costs and benefits of restoring trust in individual companies can be attributed to these entities. As no major free rider problem exists, the role of the public sector should remain limited.

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 globalisation 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.

Emmott emphasises the need for enhanced disclosure and transparency and believes that policy makers and regulators should focus on these areas in order to make markets less susceptible to excesses and more resilient to shocks. In addition, he feels that central banks should explicitly recognise asset inflation in order to pre-empt dangerous bubbles. Further, he sees a role for governments in fostering competition among rating agencies and encouraging new players to challenge the current oligopoly.

Voser also believes that central banks need to give greater weight to macroeconomic imbalances and asset bubbles in the formulation of policy. He suggests policy tools which go beyond interest rates and could include varying capital requirements over the business cycle.



Kaspar Villiger

Kaspar Villiger, Chairman, UBS

Sustainability as a dynamic process

“The markets didn’t fail; they reacted logically to politicians’ misguided incentives.”

(Kaspar Villiger)

Kaspar Villiger maintained that the principle of sustainability was an incomplete vision when applied to the financial sector and recessions were an essential phase in “creative destruction”. He cautioned against excessive crisis-avoidance strategies as leading to stagnation and even new crises, and he also warned against stifling competition, because “continuing liberalisation is essential for ensuring the creation of sufficient prosperity to eradicate world poverty.”

Villiger emphasised the beneficial effects of the financial markets on the world economy especially with regard to the tremendous growth over the last 20 years. He acknowledged that much value created had been destroyed by the crisis, but he was certain that the net balance would turn out positive.

While recognising that greed and mistakes by the banks and financial firms had contributed to the crisis, Villiger is convinced that political failures were the root cause. The US Federal Reserve kept interest rates too low for too long; inflation also remained low and it became attractive to live on credit. In addition, the US Congress put pressure on the big mortgage financiers to promote mortgages for low-income buyers. Hundreds of millions of dollars flowed into the subprime sector, creating the corresponding bubble. Villiger thought regulation only worsened the situation and that many regulatory authorities, aware that they had failed, now inclined to over-reaction.

He depicted five possible dangers in the aftermath of the crisis:

- If the central banks continue their low interest rate policy for too long, inflation or a new bubble will ensue.
- The huge national budget deficits will lead to big problems, possibly affecting some countries’ creditworthiness.
- Possible protectionist measures might affect global growth.
- Mistrust in the market economy may lead to economic policy errors.
- There might be a wave of over-regulation.

Against this background, Villiger contested it was time to fight for the market economy again. Regulatory trends came in for his particular criticism. He thought today’s regulations had intensified the crisis, and generated a checklist mentality with fear of responsibility. Too much regulation stifled creativity. What the financial markets needed was not more regulation but better regulation.

In closing, Villiger reiterated his argument that, to be efficient, the financial markets needed freedom and competition united with consensus among the market players with regard to moral and ethical values. He believed these could not be imposed by the state, but if the sector failed in this, there would strong pressure for excessive regulation.



James Surowiecki

James Surowiecki, Author and financial columnist, The New Yorker

Herd behaviour vs. collective intelligence. How we get our collective judgement right?

In his keynote address James Surowiecki explained *the wisdom of crowds* notion that lots of different inputs often result in good collective judgement. He also described the “circular mill” phenomenon of army ants marching ceaselessly round in a circle until most of them die.

These two images reflect how markets can work. In the first case, lots of individuals thinking for themselves form an accurate overall assessment. The second symbolises the problem markets often run into when institutional and psychological pressures produce ant-like “herding” behaviour. People often copy what their peers do rather than think for themselves. In Surowiecki’s view this “momentum trading” behaviour was a major factor in the crash of 2008. There is a variation, which he calls “conceptual herding”, where an irresistible dominant paradigm is established. In 2008 this was the notion in the US that house prices could only go up, and people continued acting in accordance with it despite the signs of impending disaster.

It often makes sense to copy others, but when almost everyone does so, the *wisdom* of crowds is replaced by the *folly* of crowds. The fact that everyone is merely following creates its own overpowering dynamic. In organisations, people are concerned about their reputations, and are eager to look as though they know what is going on. Behaving in a similar manner to others is one way of giving this impression.

Money managers spend a lot of time watching what their peers are doing and then create similar portfolios. Within this framework, there was an interaction of behaviours, especially those focussing on short-term gains, which led to the crisis.

By adhering to a few principles, organisations can move away from the folly-of-crowds model and leverage the collective intelligence of their employees. Promoting cognitive diversity is essential, with different people looking at problems from different perspectives. The more diverse a group is the more intelligent its decisions will be. Disagreement should be fostered because the best decisions arise not out of consensus but out of conflict. The second principle is the need for people who are willing to think independently. Allowing problems to be considered from different angles and getting people to think for themselves results in distinct benefits. If organisations can leverage the intelligence of their employees better, the collective intelligence of the markets will be greater.

Asked how diversity and information flow can best be implemented for boards of directors, Surowiecki said that boards often constitute models for how discussions should *not* be conducted. They tend to shun meaningful disagreement, whereas real argument produces better results and is more likely to happen in boards of diverse make-up.

“After a meeting, do not ask the people for their views one after the other. The last few people are very unlikely to give you their true opinion.”

(James Surowiecki)



Kai-Uwe Schanz (r), Chairman and Principal Partner, Dr. Schanz, Alms & Company AG in dialogue with
Markus Nöthiger (l), Partner, PricewaterhouseCoopers & TSF Taskforce Member

Presentation of Conference Theses

The Sustainability Forum Zürich published a discussion paper (see above) prior to the symposium. Kai-Uwe Schanz, author of the discussion paper, presented the main findings. The interviews with seven highly respected experts and business executives such as Peter Voser, Klaus Wellershoff and Ernst Fehr revealed that mispricing of risk was the main cause of the crisis: Bill Emmott explained that market participants and regulators were fooled by securitisation. A further factor was compensation structures favouring short-termism, but there was disagreement as to whether this was a root or contributory cause. Inadequate corporate governance was criticised; some boards were too close to their CEO and there was a lack of constructive dissent at board level. Regulation was deficient, and corporate risk management had proved inadequate.

As a cure for the crisis the interviewees thought transparency and disclosure should be enhanced, and stakeholders rather than regulators should push for changes to corporate business models. Corporate governance should be subject to stricter regulation, and there was need for boards of directors who welcomed dissenting views. Public policy should recognise globalisation and the downside of asset bubbles. Controversial issues were whether markets are inherently unstable, the role of compensation, market versus public policy failure, the role of regulation in restraining corporate risk taking, and the role of corporate and individual values.

Markus Nöthiger was invited to challenge the findings of the discussion paper. On the subject of trust, he countered that many people thought there had been too little mistrust in the financial markets, and he wondered whether there would now be a demand for more transparency and more responsible products or whether market participants would rather continue to accept crises. Schanz thought the players would want to carry on as before and take on the risk of crisis. He accepted that occasional shakeouts were necessary.

What would be the “right” degree of regulation, Nöthiger questioned. Schanz cautioned that over-regulation would jeopardise prosperity; initial post-crisis zeal in that area had diminished. Looking ahead to a later presentation, he considered that applying something like the ‘polluter pays’ principle would be a good idea. He found bailouts using taxpayers’ money to be one of the most disturbing features of the crisis. Regulation had not been comprehensive; it offered room for circumvention. Nöthiger asked whether there should be more concentration on principles than on rules. Schanz pointed out that regulation had been based more on principles than rules up to the time of the crisis, but after what had happened he thought the advocates of stricter rules would gain the upper hand. What might the financial sector learn from other industries? In Schanz’s view, the financial industry could do more for sustainability by returning to sound historical principles of banking, like matching assets with liabilities and deposits with loans.

Panel Discussion

Owners and gamblers – the mutuality of the financial and the real economy



Peter Fanconi, Vontobel Group;
Paul Frentrop,
APG Asset Management;
Paul Lee, Hermes

Moderator:
Ernst A. Brugger,
BHP – Brugger and Partners

Ernst A. Brugger broached the theme of shareholders. Do they behave like company owners? Do they influence governance? Do they have a long-term perspective or are they out for a fast buck?

Paul Lee explained that his equity service organisation, Hermes, encourages shareholders to assume their role as owners, calling companies to account on sustainability issues, and striving to ensure that the financial system works in the owners' long-term interests, which it certainly did not before the crisis. Corporate culture is a huge issue in Lee's opinion, exerting influence towards either short-term gain or a healthier long-term perspective. Hermes works on these issues through direct dialogue with corporate management.

Peter Fanconi thinks shareholders/investors do show understanding for long-term thinking and products and for corporate governance concerns. He distinguishes between institutional and private investors. Many private investors are poorly informed about investment-related risk and expect high, risk-free returns. The institutional investors have a better grasp of risk generally. In the crisis there is now not only a lack of trust among private investors but actual *mistrust* regarding financial institutions. To restore trust, the financial industry has to enhance transparency and improve communication.

Paul Frentrop argued that corporate governance helps to ensure the integrity of financial markets. His department works with portfolio managers, exercises voting and other shareholder rights. He thinks it is difficult, however, for organisations like his to influence firms' corporate culture or boardroom practice. APG's ultimate governance sanction is to sell its shares in any company deemed to be misbehaving. Lee commented that Hermes' clients come to the organisation because they agree with its approach to the soft issues. Although selling shares in a company is a way to express disapproval of its actions, he thinks the system would benefit if more shareholders acted like long-term owners.

Regarding "client literacy", Fanconi wouldn't expect the end-investors to have the same understanding as the asset managers, but he thinks private investors should be given sufficient know-how and information to make informed decisions. He considered that understanding end-investor profiling would be a major priority for asset managers in the coming months.

The first questioner asked why, in a greening economy, institutional investors still bought stock in "brown" companies. Frentrop wondered how far an institutional investor could move from consensus investing.

"Individuals only act responsibly once they understand what reactions you as a person are able to provoke."

(Peter Fanconi)

"What the asset manager can do depends on the risk appetite of the client."

(Paul Frentrop)



“The banks that terrify me are the ones carrying on as if the world has not changed. The world has changed and we need to own up as to what is going wrong.”

(Paul Lee)

To place investments only with a view to long-term sustainability and thereby risk underperforming the market for years is not a feasible strategy for institutional investors, Frentrop continued. For Lee, the world is greening but isn't yet green. He saw investment in brown companies as an opportunity to steer them to a more sustainable future. Fanconi observed that there was increasing demand for more sustainable, long-term investment.

A further questioner said there had been a revolution in governance thinking, but the markets had short memories. So “when the music starts again and the bankers start dancing, what will be different?” Frentrop felt that the level of integrity in the corporate sector had risen but the crisis stemmed from the financial sector, and shareholders in banks had less influence than those in manufacturing companies. The banks claimed they were prevented by regulations from responding to shareholder demands for change. Lee didn't concur: Hermes had been able to influence at least some of the banks, though exerting major influence remained a challenge.

Would implementing the right incentive and disincentive systems provide a way out of the crisis? Frentrop thought there was an enormous lack of disincentive and advocated a return to personal liability.

When banks made huge, damaging mistakes, it should be easier to make them answerable in court. This applied particularly to Europe, where there was no class action. Regarding incentives, Lee thought performance should be evaluated on a sufficiently long-term basis to match the interests of clients and shareholders. Fanconi too was an advocate of personal liability, but he saw the trend in Switzerland going in the opposite direction. Deferred incentive payment systems also made sense to him because they secured the long-term perspective.

Brugger criticised that he didn't see the big financial players acknowledging past mistakes even though that was the only way to regain trust. He asked what the panellists would change to help re-establish trust. For Frentrop, clients should be made more aware of the risks involved in managing their funds. The watchword for Fanconi was responsibility, sharpened through an entrepreneurial approach. This included understanding of and openness about the likely consequences of one's actions. Lee quoted the phrase from the welcoming address that trust was “a bet on future actions”. For him it was rather a *judgement* on future actions, and people could only make that judgement if they were dealt with honestly by those wishing to gain their trust. That included being open about what had gone wrong and about intended action.



Parallel Session

Responsible investors: The role of asset owners

Asset owners have always played an important role in the value chain of investments. But “do really all asset owners care about their investments?” asked moderator Alexander Barkawi at the beginning. Many large real-economy firms are explicitly committed to sustainability in their own operations. But as asset owners and investors – e.g. through their pension funds – they rarely take sustainability into account. Insurance firms have recently started to take factors like climate change into consideration, but only for calculating premiums and not for asset management purposes.

After presenting these examples, Barkawi turned his attention to the asset managers. What part do they play in defining their relationship with their principals, the asset owners?

Doris M. Schönemann reminded the audience that all of us have a pension plan and so we are all asset owners. As the Vice-Chairperson of the Swiss Federal Social Security Fund (AHV), she summarised what the AHV has learned from the current crisis. First, it highlights internal, organisational risks. Second, it shows that the complexity resulting from external mandates needs to be reduced. Flexibility can be regained by keeping more responsibility within the pension fund itself. Third, Schönemann stressed the importance of having a high level of financial literacy in the board of directors, a factor of particular importance in diverse, politically influenced and laymen boards. In short, the AHV increasingly relies on its own resources and strives to insource competences and flexibility.

Paul Frentrop highlighted the “home-grown” causes of the current crisis. In

contrast to earlier economic crises, it was neither the real economy (as in the Enron or Worldcom case) nor the equity markets (as in the dot.com bubble) that caused trouble. It was the banking industry itself, astonishingly enough in an established area like fixed income. On the question of who was to blame – the buyers (asset owners) or the sellers – Paul Frentrop agreed that it was a wrong decision to buy “accounting miracles” like CDOs but the legal responsibility lay with the sellers of the CDOs.

Ivo Knoepfel pointed to the lack in appropriate governance and know-how at many small and mid-sized pension funds as a major impediment toward a better integration of sustainability in their investments. He stressed the role of larger pension funds in leading the way in terms of best-practice and helping smaller funds to improve, a model that is successfully applied in countries like the Netherlands, the UK or Sweden. Knoepfel reported about Swedish research into the “behavioural” aspects of the relationship between asset owners and managers. This relationship is often characterised by mutual suspicion, inconsistencies between declared goals and behaviour, and by short-termism on both sides. This often goes against a stable, long-term oriented relationship that is conducive to sustainability integration. While many asset owners claim to have a long-term focus, their relationship to asset managers is often driven by impatience and early termination of a mandate in case of poor financial performance. This encourages asset managers to act accordingly. Knoepfel made some practical recommendations to improve mutual trust through the right incentives and structures.

Speakers:

Ivo Knoepfel, onValues;
Paul Frentrop,
APG Asset Management;
Doris M. Schönemann, AHV;
Raj Thamotheram,
AXA Investment Managers

Moderator:

Alex Barkawi, SAM

“Asset owners must lead the way because they are at the top of the investment industry’s ‘food chain’. Both owners and managers have a responsibility to foster trust, better alignment of interests and integration of sustainability in investments.”

(Ivo Knoepfel)



“We are all asset owners.”

(Doris M. Schönemann)

“Not only rights, but also responsibilities go with being owners.”

(Raj Thamootheram)

Knoepfel also recommended that asset owners declare (if possible publicly) their investment beliefs and commitment to sustainability. He also stressed the importance of asset owners more thoroughly assessing asset managers at the beginning of a relationship and then giving them a clearer and stronger mandate.

Raj Thamootheram stressed that “not only rights, but also responsibilities go with being owners”. But these responsibilities have not yet been fully taken on board. According to a recent study, only 12% of asset management mandates contained clauses on ESG (environmental, social, governance) issues. Responsible investment would need a strong signal from the investors themselves. He saw a “leadership gap” among investors.

During the discussion, it was argued that asset managers and banks are just service providers. Since their primary function is to multiply their customers’ money, little should be expected from them in the way of leadership and values. Short-termism is partly triggered by external trends like the demographic change that is putting additional pressure for higher yields on pension funds.

A consensus emerged that the initial impetus should come from the asset owners. They should know much more about their assets than the 55% of asset owners who, according to a recent study, do not even want to know. But how can people be made to assume their responsibility? Change will come most rapidly from asset owners who actively communicate their values and investment beliefs. Sincere and consistent signals are needed from them so that the whole system is influenced. Pension funds in particular should be able to codify their values much more clearly than is currently the case. PRI-signatories already send an appropriate signal, but by far not all of them have

corresponding ESG clauses in their asset management mandates.

The capacity for long-termism within the pension fund industry needs to be built up. Asset owners need guidance by experts regarding what is in their own interest, particularly as the pension fund trustees themselves (especially in small pension funds) only have limited time and resources. The fragmented pension fund landscape constitutes an obvious barrier, however. Consolidation in the pension fund industry through management vehicles would enable expertise to be concentrated with fewer decision makers. This could help to tackle leadership deficits more effectively. Collaboration between pension funds would already help. The tendency towards herding might increase through such collaboration, producing positive and negative effects on long-termism such as passive (indexed) investment strategies.

Not only the pension funds themselves need to enhance their financial literacy. Their clients (beneficiaries) also need to be educated, by the asset managers, to develop sensible return expectations. But lowering the expected returns would mean that corporations would need to contribute more to the pension plans.

The questions of how to assess asset managers and how much time they should be given to reach investment targets were the subject of lively discussion. Few CIOs survive underperformance, which their clients do not accept for more than 2 to 3 quarters. This shows that short-term thinking among asset owners is an established fact. Exit fees were suggested as an incentive to longer term investment horizons, but this measure was not acceptable to all the workshop participants. Peer comparisons were also rejected since they accelerate the race for performance.



Parallel Session

Risk modelling, systemic risk and complexity: What are the limits to diversification?

The panellists discussed the limits of quantification models of the financial markets and possible reasons why the financial crisis occurred.

David N. Bresch outlined the basic principles of natural catastrophe modelling and pointed out some fundamental differences to modelling in the financial markets. “We do not know human psychology and the workings of the economy as well as the laws of nature” he said. Scenarios and stress testing in financial modelling are therefore characterised by a much higher degree of uncertainty.

Alexander Lipton reiterated that financial crises have occurred many times in the past but are not readily amenable to modelling. While models work rather well for stock options, they do not work for mortgages, for example. Unlike natural catastrophes, disasters like the current financial crisis are likely to encompass the entire financial system, which cannot be easily modelled. As investors finally start to grasp that losses and gains are interconnected, Lipton foresees permanently lower returns on investment. Moreover, he expects a simplification and standardisation of financial instruments. A more reasonable monetary policy and better regulation instead of more regulation are therefore necessary. Lipton, however, is unsure that this will happen, because of the nature of the political process, which determines these two factors.

Paolo Vanini identified several causes of the crisis: business models, incentive schemes, risk taking vs. risk transforma-

tion, rating and pricing models and the network of the banking system. He focussed on the so far under-highlighted network effects in that system, which determine that the balance sheets of all banks are interconnected. Vanini said that we have to keep in mind that one bank’s assets are another bank’s liabilities. This has a big influence on diversification and is a factor that has not been integrated sufficiently into the models. A result of this interdependence, combined with a lack of transparency in bank balance sheets, was that assumptions regarding the risk profiles of banks were made on the basis of trust rather than hard figures. When the situation became dire, trust was in short supply and interbank lending ground to a halt. Vanini believes that this lack of trust was the real reason why regulation failed: there is no way to enforce trust on other banks. The current Basel II system is designed to regulate the individual banks but fails to deal with the systemic risks. This must be taken into account when new regulation is drawn up.

Speakers:

David N. Bresch, Swiss Re;
Alexander Lipton, Bank of America Merrill Lynch;
Paolo Vanini, Zurich Cantonal Bank

Moderator:

Thomas Streiff, TSF

“That we have never seen it does not mean it never happens.”

(David N. Bresch)

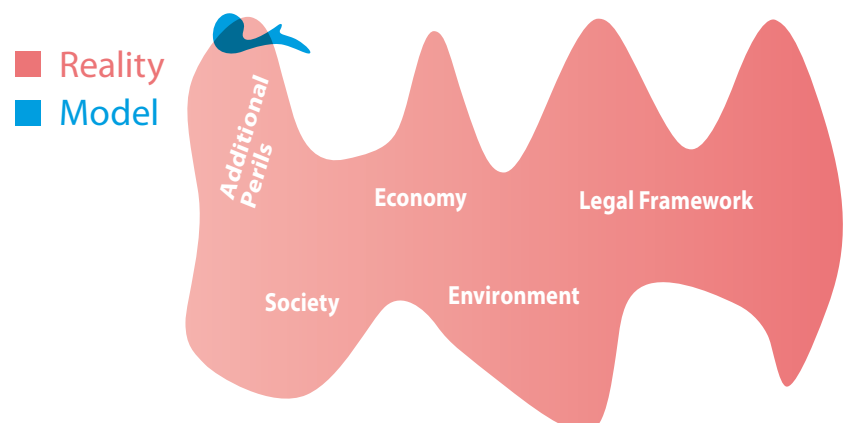
“Economics is the weakest link in financial modelling.”

(Alexander Lipton)

“Our models can describe many factors, but explain only few.”

(Paolo Vanini)

Reality and Model: Proportions (Source: Swiss Re)





Speakers:

Jermyn P. Brooks,
Transparency International;
Sean J. Egan,
Egan-Jones Ratings Company;
Alexander Ohl,
Union Investment

Moderator:

Yasmin Osman, Handelsblatt

*“What went wrong?
One thing we can all
agree upon is that the
most outstanding factor
was the failure of risk
management.”*

(Jermyn P. Brooks)

*“Banking has been placed
next to the payment
systems – and it’s like
putting nuclear power
plants next to missile
testing sites.”*

(Sean J. Egan)

Parallel Session

Risk management, ratings and information asymmetries: Setting the rights incentives

The failure of rating agencies to accurately assess highly leveraged business models and complex, innovative financial products played a major role in bringing the world to the brink of economic disaster. Ratings are used throughout the financial system as a measure of risk and as a basis for regulating capital. They matter less for liquidity, but are essential for structured products. A variety of stakeholders need ratings: investors looking to accurately assess their investments, regulators, banks and firms looking for financing.

The problem, as Alexander Ohl described, is that the task of rating as being a credit opinion for measuring potential risks has been outsourced to rating agencies. In the past, there was a clear system of checks and balances and the focus was on accurate credit analysis. Today, almost all of those checks and balances have been replaced by layers of brokers, bankers and risk assessors who are all incentivised to “get the deal done”, and who are paid regardless of the final outcome. Sean J. Egan explained this lack of a proper system of checks and balances allowed for the development of products such as subprime mortgages, option arms, Alt A and “o” money down – and this pushed the market to its breaking point.

Moody’s, S&P and Fitch were all very profitable; as Egan put it: “We’ve never seen an industry like this – 50 percent margins and a massive revenue base.” And because so many stakeholders are dependent upon ratings, these agencies are also very powerful. The primary problem is the fact that rating agencies are paid by those needing the outcome.

This “issuer pays” system evidently leads to the potential for serious conflicts of interest. Accuracy is not always the first priority in the ratings process; instead, speed and giving the highest rating possible often trumps everything else. Therefore, ratings are often not realistic.

How should the current ratings system be changed? Jermyn P. Brooks proposed the following measures, which are similar to the approach employed by auditors/consultants after the Enron scandal: companies should not be allowed to consult to the companies they rate. Regulations have to be tightened. Rating agencies need to be more transparent about how the ratings are determined. Stricter rules to prevent conflicts of interest are necessary – ideally the payment for the services should be disconnected from the providers of the services. By analogy with an investment analyst approach, pay for rating services should vary depending on the extent of investigation undertaken and the longer-term accuracy of the ratings. Ohl added that it is important to put the responsibility back on the investors.

Egan, himself operating on an “investor pays” model, cautioned that if the “issuer pay” business model retains its prominent role in the financial industry, then rating shopping will continue. It will be difficult to change this because “ratings are embedded in the financial system – it’s impossible to remove them”.



Parallel Session

Corporate governance and shareholder engagement: A valuable investment in trust?

David P. Frick made a subtle distinction between corporate governance as a function of external regulation and good governance generated within companies. He argued that failed corporate governance structures played only a minor role in the current crisis. The really important factors are the way companies are run internally and the corporate culture. Despite some useful international initiatives put forward by various governments, the potential offered by further regulation is very limited. More regulation might even be ineffective or have harmful side effects such as restricting boards in their flexibility. Boards should rather be strengthened in their function as guardians of the long-term interests of their companies and should work together with senior managements to set the right tone at the top, fostering an appropriate culture and worldwide standards of behaviour. Sustainability-oriented measures in day-to-day operations are crucial, creating trust by underpinning the company's ethical principles. In line with this thinking, Nestlé quite a long time ago formally set out in its corporate principles its commitment to a long-term approach to both culture and value creation. For Frick, initiatives aimed at good governance may not have helped to avoid the crisis, but remain critical. Ultimately, it comes down to people and their judgment.

Gregor Greber underlined the importance of the Annual General Meeting (AGM) and urged shareholders to be active. An AGM with a low participation rate not only shifts power to general management but also yields inappropriate rules. In Switzerland some aspects of

the power mismatch between shareholders and management could be dealt with by amendments to the Swiss Civil Code. The rights of shareholders should be strengthened and the principle of "one share, one vote" should be enforced. BoDs have to be independent: representatives of the major shareholders, company executives, persons who are mandated or used to work for the companies cannot be considered independent. The accumulation of too many mandates by individuals should also be forbidden.

Professor Osterloh said the crisis could have been managed better if BoDs were more diversified. Diversity generates a more creative way of solving problems through a broader range of knowledge, skills and perspectives. Unduly risky behaviour is reduced in gender-diverse boards, because women tend to be more risk-averse and less overconfident than men. An open discussion culture, the cornerstone of Surowiecki's "neutrality, decentralisation and aggregation mechanisms", is vital for BoDs. Osterloh felt strongly that BoDs needed to introduce fixed salaries for investment advisors. People rewarded mainly or solely on the basis of performance tend to concentrate on easily measurable short-term factors. Less measurable factors like honest behaviour are then ignored. It attracts more extrinsically motivated people. She explained the crowding-out effect: when intrinsically motivated people are forced to act under external control, their intrinsic motivation is reduced. They enjoy their work less and feel less obliged to respect pro-social norms of honesty.

Speakers:

David P. Frick, Nestlé;
Gregor Greber, ZCapital;
Margit Osterloh,
University of Zurich

Moderator:

Kolja Leiser, TSF

"If we look at the new regulations that are being composed now, there is a risk that we are regulating the last crisis instead of the next one."

(David P. Frick)

"Shareholders should be forced to exercise their voting rights."

(Gregor Greber)



Thomas F. Cooley

Thomas F. Cooley, Dean, Stern School of Business, New York University

Financial instability: Should the ‘polluter’ pay?

“I believe that financial markets will thrive in environments, which are regarded as safe. Unregulated markets will not necessarily be regarded as safe in the future.”

(Thomas F. Cooley)

Thomas F. Cooley agrees that financial crises are a recurring phenomenon, but he sees no “Schumpeterian” benefit from them and considers them to be a mystery. He finds it useful to analyse them, however, to establish which responses have been successful and may help us to avoid similar crises in future. Approaches to financial crisis are usually descriptive, offering no prescription for avoidance. The “quant-event” liquidity crisis of 2007 occurred because of a build-up of systemic risk. Initial responses to it created financial institutions that were too big to be allowed to fail, and this only increased the systemic risk. Confronting the key causes of systemic risk will form the core of any strategy to create a sustainable financial architecture.

For Cooley, environmental policy carries useful lessons for finance. Society reacts to pollution through the “polluter pays” principle, charging the polluter for controlling the causes or for the necessary clean-up. Production companies may transfer the costs to their customers as higher prices or to their shareholders through lower returns. The economy thus reinforces environmental policy.

Market failure in global finance is not so different, essentially involving financial pollution. So it could be dealt with through a “polluter pays” principle harnessing market forces. Cooley is convinced that bail-outs of institutions that are too big or too important to fail will unfortunately still form part of people’s expectations going forward. He paints a picture of a “cohort of financial

Goliaths set free to wreak havoc but immune to failure”. His proposal is to recognise the risk that forms the core of market failure and make those who incur it pay for insuring it.

The environmental polluter pays principle has positive effects on efficiency and drives innovation, and the same can be true for the world of finance. Cooley sees three conditions for its success:

- We have to be able to measure the systemic risk.
- We have to price it.
- We have to charge those who create it.

Regulatory measures should be taken to impose charges on the shareholders and clients of financial firms that create systemic risk. Such firms would probably seek the most efficient ways to comply. A rules-based approach founded on the proper pricing of systemic risk would help to ensure sustainability and resilience. Cooley considers it unlikely that there could be global coordination of systemic risk regulation, but thinks that individual countries or groups of countries could handle the issue efficiently through regulation in their territories.

He is aware that the lobbyists are already working hard in Washington against potential post-crisis “over-regulation”. He recognises that there can be good and bad regulation, but stresses that good regulation does not mean no regulation.



Sean J. Egan

Sean J. Egan, Founding Partner & Managing Director, Egan-Jones Ratings Company

Ratings as a top sustainability issue. The role of inflated ratings in the crisis

In the crisis, the major rating agencies failed to warn investors about the credit risk associated with some of the big players who collapsed or came near to it. Lehman Brothers was still receiving excellent ratings only days before it filed for bankruptcy. The basic problem is the conflict of interest created by having the issuers of securities pay the rating firms who are assessing their creditworthiness. Issuers can shop around for the best ratings and the agencies themselves have an incentive to provide them; they may even compete to provide the highest ratings in given cases. Pre-crisis experience showed that mainstream agencies adopting stricter standards lost market shares.

There are other rating organisations, like Egan's, that are paid by the investors rather than the issuers, so for them there is no conflict of interest. Egan's company, due to its independence, has a solid history of advising investors early on about issuers' poor creditworthiness. It gave timely warning of Lehman's difficulties when the main agencies were still awarding that company top ratings.

There has been a shift in the way assets are funded and credit is provided. Together with the old principle of 20% down and 80% borrowed, there used to be three levels of checks and balances: evaluation by local banker and credit officer, reviews by the credit committee and by the bank examiner.

The focus was on accurate credit analysis and achieving the right balance. In the new funding system operating before the crisis, mortgage brokers, mortgage bankers, investment banks and risk assessors were all paid on flow and could be quite reluctant if loans couldn't be paid back, because there was little or no recourse. In Egan's view, the rating firms were largely responsible for this unhealthy shift. They had taken the place of the old system of checks and balances, but had assigned high credit ratings in cases that were totally inappropriate. The system was set up for serial failure. Egan thought it would take a long time, certainly more than five years to repair it and rebuild trust.

But he doesn't consider the situation hopeless. He maintains that the problem is now well understood, and several bills addressing the issues in the financial industry are in the pipeline. With an updated approach involving an alignment of incentives, a review of investment guidelines and bank risk weightings and good stewardship, the hurdles to normalcy can be cleared.

Asked why the rating agencies were needed at all, considering their dismal performance. Egan replied that when rating was done properly it saved investors the trouble of evaluating companies themselves and it reduced friction in the market

“Reckless lending and borrowing pushed the market to the breaking point and trashed the securitisation ecosystem.”

(Sean J. Egan)



Bill Emmott

Bill Emmott, former Chief Editor, The Economist

The crisis – a creative break or just a redistribution of power?

“To me, the most important thing to be achieved is the enforcement of transparency. So much of what went wrong was due to the fact that so little was known about risks, volumes of business and who the counterparties were.”

(Bill Emmott)

There are currently two related economic cycles in the world. The western cycle, taking in Western Europe and North America, is an economic downturn driven by a crisis in the financial industry and dealt with by a mixture of nationalisation and subsidisation to prevent further collapse. The prospect of recovery is accompanied by a risk of deflation and a reduction of the amount of leverage in the system. The second economic cycle is going on in the emerging markets, especially China and India. It began with rapidly rising inflation in the first half of 2008 and was a recession induced by anti-inflationary policy. There is the prospect of a slow, deflation-led recovery in the West, but we don't know what its main drivers will be. The heavy burdens of higher taxes, huge public debt and enormous subsidisation of the financial industry will need to be dismantled. In Asia a more rapid, “traditional” recovery is possible.

Regarding potential “creative breaks”, Bill Emmott does not think there will be a geographical break involving a redistribution of power from west to east. The development of the Asian economies will continue but has not been materially accelerated by the crisis. What may speed up the apparent transfer of power to China would be the floating of the country's currency, the Renminbi, which Emmott expects to happen in the next three to five years.

With regard to a sectoral break, it seems probable that the finance sector will not be as important in the next ten years as it was during the last ten. The behaviour of the financial institutions will change and there will be a government-imposed decline in their profitability. We don't know what changes will be made to capital and disclosure requirements or what measures will be taken to prevent companies from being too big to fail.

It is difficult to predict whether there will be a psychological break. During Japan's “lost decade” of the 1990s, companies there kept reducing debt out of fear of deflation, and thereby unwittingly reinforced the deflationary process. If something similar happened in the European and US economies, the results would be a really big economic change.

An environmental break may well now be under way, and it could be a truly creative break. As we emerge from an economic crisis regarded as the most serious since the 1930s and despite a big fall in demand, the price of oil is double what it was in March and three times higher than in 2000. Changes in environmental politics and in particular the high price of oil will be a huge incentive to technological development aimed at substitution of fossil fuels. So the end of an age of dominance by the financial sector may also represent the end of the age of oil, which began about 100 years ago and has dominated our economies for the last 50 years.



David Blood

David Blood, Senior Partner, Generation Investment Management

Corporate culture in the financial service industry

Sustainability entails recognising that environmental, social, governance, reputation and long-term economic factors are essential components of doing business. Acting in terms of sustainability ensures revenues, competitive positioning and profitability. It's not just a nice-to-have, not only an environmental factor but also a driver of business gaining in relevance as the business context changes.

Financial services can be roughly divided into two areas: service oriented and capital-intensive oriented business. But the common denominator in financial services is that of people and trust, both vital components of culture. David Blood finds it remarkable that people in the financial services industry don't focus on first and foremost. The financial institutions that have failed or had serious control and compliance challenges are those that had a flawed culture and no awareness of sustainability. The deficiencies were in leadership, governance, incentive structures, transparency and often integrity and ethics — that is sustainability. Following the crisis there is now more than ever a need for discussion about what is really important for financial institutions, and in specific cases about what form the culture takes, what the incentives for employees are, how decisions are made regarding the products to be offered, and whether ethical and regulatory factors are adequately considered. How can companies build and guard the trust that will drive their success?

Incentive structures need to be rethought. If people are compensated in line with a short-term horizon, that is how they will operate. Asset owners themselves have a duty to think long term and with a view to best practice. If asset managers are compensated on a short-term basis, they probably won't examine the long-term strategies of the companies they invest in. There has to be a move away from the notion that what happened in the last quarter and what's going to happen in the next quarter are the only relevant factors. Although important, they don't drive the success of an organisation and should not determine the evaluation of managers or their incentive structures.

In David Blood's opinion, the crisis came about because responsibility was neglected or disregarded. The cost to the economy and to many people who had nothing to do with the financial services industry has been terrible. Investors too disclaimed their responsibility by going along with what was offered, unconcerned about management, leadership or best practice. Blood concluded with the thought that, following the current transition phase, the financial services industry landscape will change dramatically. The businesses which will survive and flourish will be those that embrace the notion of sustainability as relevant to their success and as the driver of their culture.

“The discussion paper covers much of the things we have to change: regulation, risk management strategies and accounting. But we also have to account for transparency, we need to encourage the discussion about what is important about our financial institutions, how the culture operates, how we incentivise employees, what products we're developing and whether these products are proper, how we protect our license to operate and the trust that drives our success.”

(David Blood)



Speakers:

Eric Breen, Robeco;
Marco Curti,
Zürcher Kantonalbank;
Michael Imholz, BCG

Moderator:

Kolja Leiser, TSF

“We have to view incentive structures in a holistic way – and to get behind the numbers and ratings.”

(Eric Breen)

“Putting limits on pay should not be the job of the government but rather of responsible managers.”

(Marco Curti)

“You can create a people advantage during the crisis.”

(Michael Imholz)

Parallel Session

Incentive structures in HR: how to balance taming and promoting the best and the brightest?

The current crisis revealed a widening split between the aspirations of individual employees of banks and the long-term goals of their organisations. How should corporations shape their relationships with their employees? What incentives should they offer them to make them a powerful element of long-term success?

The panel members agreed with the statement in the discussion paper that “flawed incentive structures have fuelled corporate risk taking and contributed heavily to the depth and breadth of the crisis”. They even thought the importance of that factor had been underestimated. Erik Breen explained how investors may approach incentive structures in their investment portfolios: Shareholder voting rights can be used to hold boards accountable for the incentives both at the top and on the employee level. Robeco’s analysts investigate whether these incentives support the long-term strategy of the company, helping to ensure continuity and stability and a balanced risk management. As stock performance should only be one possible element in determining salaries and bonuses, Breen suggested considering qualitative indicators, such as employee and client satisfaction, in employee remuneration.

According to Marco Curti, financial incentives are just one instrument for motivating and rewarding high-performing employees. In the financial industry and elsewhere, high performers are nowadays asking for things beyond the pay slip, such as new challenges and growth opportunities, high-quality training and educational programs.

An intellectually stimulating environment, sufficient autonomy, varied tasks and the possibility of having a good work-life balance are regarded as high-quality rewards. Kolja Leiser asked why, then, UBS-employees had recently quit their jobs “just” because bonuses were lowered. The panellists agreed that this was not necessarily a sign of pure “greed”, but rather of frustration and a lack of a shared vision. Michael Imholz said that there were many HR measures to retain and motivate employees, even in times of crisis when no high bonuses could be paid. He mentioned retention measures such as flexible compensation, job mobility, flexible pensions, taking on temporary staff to relieve pressure, establishing seasonal hours, job-sharing or work-hours accounts, and promotion of sabbaticals. Imholz admitted, however, that, few companies actually implemented such options, even when they were theoretically on offer.

The bonus explosion began within the financial industry, particularly in investment banking. The idea was to reward product developers for successful innovations, explained Curti. However, changes are already occurring in incentive structures. Curti thinks the power of profit to dictate compensation will be reduced in the long-term. Bonus models have already been modified and in many cases guaranteed bonuses have been prohibited.

The consensus of the session was that unbiased career assessments and development plans are key in motivating high-performers and helping to ensure corporate success.



Parallel Session

Trust and reputation: the corporate dimension

Can trust be rebuilt? Godfrey-Davies is confident that it can, and HSBC will restore trust by continuing to take the cautious approach of the last 150 years, striving to hold as much capital as possible and lending only when deposits are adequate. HSBC recognize that as the balance sheet is merely a snapshot, the only way to know how the business is going is to know the customers. For Deutsche Bank, sustainable behaviour is key to reputation and trust, which is why it is committed to the UN Global Compact, Principles for Responsible Investments, OECD guidelines for multinational companies, and other principles.

“No transaction is worth risking the good reputation of our bank” is one of the bank’s statements in this context. For both panellists, transparency and accountability are the central instruments for rebuilding trust. Worried that the financial sector could fall back into old behaviour patterns, it is hoped that the G8 will come up with solutions to prevent this. Stakeholder behaviour will also be a powerful guiding force.

Could the financial crisis have been avoided with effective reputation management? Deutsche Bank already has introduced systematic reputational risk management. Within Deutsche Bank it is part of the overall risk management. HSBC started to institutionalize reputational management in 2008. Previously, HSBC had no overall structure in place for tackling reputational issues; it was managed at head office by a number of departments. Two years ago, HSBC created the Group Reputational Risk Committee (GRRC) with the primary task of devising policies and principles.

The GRRC feeds into risk management and reports to the Group Management Board. Godfrey-Davies argued that today’s problems would not have been avoided even if this reputational management structure had been in place earlier, because the GRRC does not examine potential decisions taken by the main Board. In the future however, Godfrey-Davies believes, HSBC’s decision makers will place greater significance on the reputational impact of their actions. Hölz considers governance of the utmost importance for preventing financial crises.

How should a bank react in a financial crisis? HSBC Chairman Stephen Green publicly accepted the responsibility of financial institutions at a recent conference in Frankfurt. While not all the criticism of banks had been justified, he said, there was a case to answer in some circumstances.

Asked what one thing they would like to change, Godfrey-Davies wished for more interaction between top management and employees, while Hölz called for still more transparency and accountability, as a basis for trust.

Speakers:

Ivor Godfrey-Davies, HSBC;
Hanns Michael Hölz,
Deutsche Bank

Moderator:

Olivier Jaeggi, Ecofact;
Susanne Stormer,
Novo Nordisk

“There is nothing wrong with being wrong. But you have to say so when you realise you are.”

(Ivor Godfrey-Davies)

“Trust is not only built by CEOs but also by the local representatives interacting with the customers.”

(Hanns-Michael Hölz)



Speakers:

Paul Clements-Hunt, UNEP Fi;
Ralf Frank, DVFA;
Daniel Mahler, A.T. Kearney;
Burkhard P. Varnholt,
Bank Sarasin

Moderator:

Sabine Döbeli, Bank Vontobel

“The risk side is clear. The opportunity is incredibly exciting. Any investor who is not looking at this opportunity is asleep at the wheel.”

(Paul Clements-Hunt)

“In the post-Kyoto framework you will have carbon on your balance sheet.”

(Ralf Frank)

“Better performance is the plain and simple way to convert the mainstream investment community to sustainability approaches.”

(Burkhard P. Varnholt)

Parallel session

Sustainable investments: a catalyst of trust and stability in financial markets?

Transparency, quality and availability of data related to sustainability factors were recurring themes throughout this session. While arguments were made for mandatory disclosure of extra-financial information, Ralf Frank countered that this may not necessarily be the right data to ensure that the critical issues are being addressed. Paul Clements-Hunt called for a rewiring of the market, improving information flows and the way pension funds – buy and sell side – and clients connect. The panellists were cautious about strong regulatory initiatives fearing that these would turn out to be excessive or ineffective. Burkhard P. Varnholt pointed out that the sustainable investment movement has largely operated without governments so far and that market penalties, raising the costs of capital for unsustainable companies, was the best way to align agendas.

According to a study by A.T. Kearny, the companies perceived as more sustainable outperformed their industry peers in 16 out of 18 industries. The successful companies had a stronger focus on long-term health, vigorous corporate governance, sound risk management practices and a history of investment into green innovation. Daniel Mahler confirmed that there is a search for “true value” among investors. Varnholt reported that the Sarasin sustainability portfolio outperformed the market over the last 5 years. In the last 12-18 months outperformance rocketed to 400-500 basis points. They also received an avalanche of requests from institutional clients.

The disconnect between the proliferation of glossy CSR reports and the actions of individual investment professionals came up several times. Frank pointed out that policy statements had not yet cascaded down to the majority of analysts. Often the only sustainability risk they consider material is reputational risk. Clements-Hunt assessed the experience with the Principles for Responsible Investments. However, many signatories have yet to demonstrate that they are translating their commitment into serious action. Clements-Hunt confirmed that with regard to the risk side, the materiality of sustainability issues, such as resource depletion, water scarcity or human rights, has been demonstrated and is recognized. But the change in perception still needs to translate into operational change – even among committed financial institutions. Frank recommended paying more attention to fixed income and lending, as opposed to the current focus on equity, as an opportunity to further break down sustainability approaches to the level of the individual investment professional.

Clements-Hunt stressed the opportunities in the transition to a low-carbon economy and sustainable cities. Other suggestions on pushing the agenda included smart financial products, harnessing the public policy impact on markets, more imagination in terms of investment origination and new products addressing future client demands, a focus on credit desks rather than investment firms and changing investment mandates and Requests for Proposals for Asset Managers.



Parallel session

Corporate values: are traditional virtues in conflict with market incentives?

According to Professor Nick Lin-Hi the major challenge facing companies is to live up to their professed values under the constraints of daily business such as time, pressure and the budget. While most companies claim to uphold the virtues of integrity, honesty and transparency, few develop either ways of translating these values into their daily operations or mechanisms to support them. Resolving these conflicts would provide the basis for future returns and trust.

A common cure sought in times like these is more regulation. German Egloff cautioned that structured financial products are far more challenging to regulate than issues such as child labour or workplace safety. In the discussion, doubts were expressed that politicians would know enough about the field to draw up appropriate rules. It was argued that the crisis was anyway politically induced in the first place and that politicians have conflicting aims. It was also contested that by strongly regulating ethical behaviour, the willingness of each individual to do more than the rules require might be eroded. This will not lead to *more*, but *less* ethical behaviour. Egloff pointed out that increased regulation results in large compliance departments, which are already common in the Anglo-Saxon world. When ethics and values are delegated to special departments and compliance officers, an attitude of irresponsibility is fostered among the employees and values are no longer internalised. To enhance ethical behaviour, management has to lead by example and engage in a dialogue on the subject with their staff

and society at large. It is important for employees to understand the spirit and purpose of the regulations and for the regulations to be supported by adequate governance structures. *“As long as individuals who behave in an ethical, value-driven way pay for it with losses in their personal career and as long as ethical behaviour is not honoured by management, we cannot expect people to behave ethically”*, Lin-Hi declared.

Heinrich Wiemer added that values go beyond regulation, bonuses and incentives, which are all necessary but not sufficient on their own. He explained what can be learnt from family businesses, which focus primarily on customer benefits. Quarterly results and stock quotations don't distract those entrepreneurs from the long-term development of the companies. Wiemer stressed that it is important that investors are intrinsically motivated. They should invest in companies where “brain and heart” prevail. Egloff suggested that companies' decisions have to be transparently disclosed so that the investors can decide in accordance with their own sense of responsibility whether a company decision is ethical or not.

For Lin-Hi, companies ultimately exist in order to serve society's purposes. Companies exploiting their liberties aggressively behave unsustainably, at the risk of their licence to operate. Self-regulation would be in their own interest but is costly and unpopular. Companies need to realign their values with the values of society, which must take into consideration the legitimate interests of the non-proprietors.

Speakers:

German Egloff, Baloise Holding;
Nick Lin-Hi,
University of Mannheim;
Heinrich Wiemer,
Capital Market Strategies

Moderator:

Sandra Hedinger,
Swiss Life

“Compliance, rules and ethics are increasingly becoming a specialist's function. As soon as we need specialists for all these questions, the values are no longer internalised by every employee.”

(German Egloff)

“The classic model – maximisation of corporate profits leads to maximised social welfare – is flawed, or else a crisis would not have occurred.”

(Nick Lin-Hi)

Panel Discussion

After the crisis: Can Switzerland become a hub of sustainable finance?

Day 2

11 September 2009

Peter Gomez,
Swiss Stock Exchange SWX;
Martin Maurer,
Foreign Banks in Switzerland;
Zeno Staub, Vontobel Group

Moderator:
Casper Selg, Swiss Radio DRS



Zeno Staub argued that wealth management is vital for Switzerland, because it is the root of the country's financial success. To handle it well, elements of sustainable finance need to be integrated: protecting clients' buying power, property rights and privacy.

Martin Maurer cautioned that foreign and Swiss banks might move out if regulation (for example to drive sustainable finance) were considered problematic. But ethically and sustainability oriented banks might be especially attracted to open branches in Switzerland when the country took up such issues. Peter Gomez thought Switzerland had always been highly attractive because of the high quality and would therefore continue to attract money, especially when taxation was harmonised internationally.

Asked whether the Stock Exchange's rules fostered short-term thinking, Gomez argued the exchange was merely a market place, whereas quarterly reporting was dictated by law. The reporting possibly favoured short-term thinking, but investors' desire for rapid gains was also part of that problem. The stock exchange provides a solid infrastructure for Switzerland. Most of the products responsible for the financial debacle were not traded over the stock exchanges.

Selg wondered what would have to change to establish Switzerland as a hub of sustainable finance for the foreign

banks. Maurer distinguished between the idea of a centre based on a sustainable business model and the notion of a centre providing sustainable products. The clients would anyway decide themselves how to invest their money. The sustainable business model was feasible for him, but he felt that Switzerland tended to take a riskier approach and was enthusiastic about innovative products. In addition, it was difficult to know, in his opinion, whether the economy was on a sustainable growth path or in a bubble. Staub advocated stronger leadership of the Swiss asset owners. They should demand for institutional design and regulation in favour of making Switzerland a hub of sustainable finance.

On corporate governance, Gomez thought that the banks in particular had learnt a lot. Switzerland was already working effectively towards sustainability. Additionally a high-level working group drawn from the financial industry and the Federal Administration is developing a strategy based on four pillars:

1. A level playing field regarding taxation, in international terms.
2. Maintenance of privacy.
3. Stable systems with built-in shock absorbers. The National Bank did one of the best jobs in the world in responding to the crisis.



4. Integrity is explicitly stated to be central to the strategy.

Gomez added that Switzerland was leading the way in working towards a financial system of irreproachable integrity and he thought this could be a competitive advantage.

Questioned whether the Swiss banking industry was providing sustainable products, Staub explained vehicles for clean investment were on offer, for example in novel low-carbon technologies. But he conceded that this was still niche business.

The moderator wanted to know what Switzerland could build on to achieve the aims described. Maurer thought Switzerland was well on the way to becoming a hub of sustainable finance. The country had a huge amount of asset management know-how and product knowledge that could be deployed in the direction of sustainability. In addition to what it offered in terms of privacy, Switzerland also offered an extremely high level of security. Probed about transparency, Maurer declared it was not possible to be transparent about everything, but measures could be taken to ensure transparency on specific issues.

Selg pointed out that everyone agreed regulation was necessary, but opinions differed regarding the extent. Gomez countered that a master plan for Switzer-

land as a financial centre had been produced by the Federal Administration and industry working together four years ago. Since then the two groups had regular exchanges on how Switzerland could remain a healthy financial centre. This approach yielded good results. The Swiss National Bank and the financial market authorities also attend these meetings, and as a result communication pathways to and from the authorities are short and relations are good.

Selg enquired whether sustainability now figured as a theme in business teaching. Gomez explained that his university (St. Gallen) was the first in Switzerland to set up a department of business ethics and they had had an institute for ecology and economics for over twenty years. The students were being made aware of ethical issues. But it was not possible to do a great deal for the moral education of future managers, since personalities were usually formed by the time the students came to university.

Questioned about Vontobel's participation in Scoach, the European exchange for structured products, Staub strongly advocated the listing, trading and settling of derivatives, and especially credit derivatives, through centralised exchange places. This enhances pricing quality and reduces operational and credit risk.

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The Sustainability Forum Zürich

The Sustainability Forum Zürich (TSF) is an independent, non-profit, non-partisan association, founded by leading representatives from business, science and public authorities from Zurich and increasingly joined by financial market players from throughout Europe. It has the purpose of organising and realising the annual International Sustainability Leadership Symposium and other dialogue events as well as connected research and promotion of projects, in particular as pertaining to the sustainability topic relevant to the financial market.

Objectives

TSF provides its members and partners with a dialogue platform that enables the exchange of the most cutting-edge knowledge, experiences and opinions on challenges relevant to the financial market. Companies, experts and scientists, other financial market players, asset owners and capital market regulators are invited to

- “Get fit”: Getting the main players fit through early recognition of financial market relevant, social and geopolitical issues and trends;
- “Challenge mind-sets” of the decision makers in financial sector with respect to their social responsibility, the resulting challenges and of the financial market players with respect to their innovation and communication capacity;
- “Promote options for actions” of the financial market players. The ambition is to improve the efficiency and effectiveness of market practices and instruments and to simultaneously create societal added-value.

TSF’s symposia to date:

2000: Sustainability – Driver to Economic Success?

2001: Financial Services – Drivers to Sustainability?

2002: Governance for Sustainability: Making Corporate Responsibility Work

2003: Towards a More Sustainable Retirement System: The Quest for New Governance and Asset Management Strategies for Pension Funds

2004: Business Investment in Development: Experiences and Perspectives

2005: The Market Value of Reputation

2006: From Short- to Long-Term: Who Cares? Institutional Investors, Beneficiaries and Investees in Dialogue

2007: Demographic Change and Financial Services: a Short List of Threats – a Long List of Opportunities?

2008: Capitalising on Natural Resources: New Dynamics in Financial Markets

Vision

TSF seeks to contribute to sustainable business in the dynamics of globalisation by promoting forecast, reflection and action in and through financial markets and its key players.

Mission

TSF aims to take up topics relevant to the future, by way of an action-oriented dialogue with internationally recognised topic leaders and decision makers, enabling the integration of entrepreneurially relevant sustainability principles in the financial market.

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des Kantons Zürich**

 **VONTOBEL**