Tomorrow's Capitalism

Towards an Accountable Capitalism

By Stephen Davis, Jon Lukomnik and David Pitt-Watson

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Introduction

The credit crisis has been a systemic failure. Though the press primarily blames the bankers for our problems, the failure was not that of one single set of agents.

In this paper, we try to set out some of what went wrong, and how we can develop a framework of policy and institutions needed to ensure a vibrant and stable financial system in the future. This, we believe, will require new thinking about the type of institutions on which a successful modern financial economy depends. In particular, we will focus on the relationship between each of these institutions and how it is possible to get them to work in a way that will support open and effective capital markets.

Our aim is not to lay out a detailed framework for bank solvency or accounting regulation though we will touch on many examples of reform. Rather, it is to try to clarify the principles on which any responsible Bretton Woods-style remaking of the market system will rest, and how these might be applied to the banks and other institutions where finance is raised to keep the economy going.

As we argued in *The New Capitalists* (Davis et al 2006) a successful economy is not just about the tensions between two separate poles: regulation or market. An economy that works effectively is like a political system that works effectively: it has checks and balances, accountabilities and responsibilities, information flows and cultures. If we are to repair our broken financial system, we will only do so if we break free from bipolar thinking. Of course regulation is important. But there are five central principles on which a successful financial system will depend. These are that:

- The entities in it are *responsible* for their actions.
- They will be responsible if they are *accountable*.
- Those who call them to account will need *relevant information*.
- That information must be *independently prepared*.
- And just as a healthy political system hinges on the scrutiny of vigilant citizens, a successful financial system will need the oversight of *vigilant market participants*.

What went wrong?

Before we offer a model for a better form of capitalism, it is worth reviewing what went wrong with this one and identifying where the five principles outlined above were lacking.

Read the press, and you will find a litany of culprits. They begin with bankers who are blamed for lending more than was appropriate, and who were caught flat-footed when depositors asked for their cash to be returned. Their culture is viewed as being greedy and short term. Regulators also come in for criticism. How come they did not see this was going to happen? After all, they knew what the banks were doing. Why did they not put a stop to it?

What about all those eminent men and women who sat on the boards of the banks? Surely they knew the risks that were being taken? What about the accountants who declared these banks to be solvent? And the credit rating agencies who told us that the debt was investment-grade – fit for widows and orphans – when it later turned out to be toxic. Or the banks' investors, who did little to stop the free-for-all?

Highlighting a litany of miscreants misses the point. It was not one individual or institution that was to blame: it was the entire system. Each of the 'players' was seeking to maximize its own interests in ways that were perfectly within the law. If they were asked if this was OK, they would have pointed you to Adam Smith, who famously observed in *The Wealth of Nations* (1776) that 'it is not from the beneficence of the butcher, the brewer and the baker that we expect our dinner, but from their regard to their own self interest'. In a similar vein, it was through the self-interest of the bank, or the mortgage broker, or the credit rating agent, or the accountant, that we ended up with our mortgages and other borrowings. Except this time, the collision of all these self-interests brought the system to its knees.

Let's plot what happened.

At the heart of the problem was the way banks thought about risk. They worked on the simple truth that if you take lots of small risks, you are less likely to lose all your money than if you take one big risk, and banks began to diversify their risk-taking activities. In the realm of mortgages, this went to an extreme, as banks and other financial institutions began to sell off parts of their mortgage loans and to buy loans originated by others. Soon, financial engineers repackaged diversified pools of mortgages into structured products (known as 'collateralized debt obligations' or CDOs), allowing instant diversification with a single purchase.

What did this mean in practice? In the old days, a bank might hold lots of mortgages from people living in a particular town. That would be quite risky, because if, for example, the local industry failed, the bank would be under pressure. So it needed to hold lots of reserves. Through the use of these newly created CDOs, banks could now own a part share in a myriad of mortgages from literally all over the world. And because that meant banks had less risk in total (theoretically), they would be able to lend more. Lend they did, with a vengeance.

The result was a huge increase in the number of loans made using the same capital base and a decline both in the interest rates charged for the loans and in the toughness of lending standards. So for example, it was possible for purchasers to borrow more than the value of their house. This in turn forced up asset prices, such as those of houses and company shares. Home owners and buyers of companies felt they were on a one-way bet, so they borrowed and bought more.

All this was sanctioned by banking regulators acting in accordance with international agreements on banking solvency, known as the Basle agreements. In fact, a new regulation, Basle II, had come in to force just before the crisis exploded. It is ironic that Northern Rock, the first British bank to need government finance, was telling its shareowners only a couple of months before it tumbled that it would be able to repay money to them because Basle II regulations meant it was overcapitalized!

Why did we lack the vigilance to question these practices? Why did we not hear the whistles blowing a warning? For the truth is that many voices had suggested a mounting crisis.

Perhaps we suffered from what social psychologists call the 'bystander effect': because there were so many bystanders, no one saw it as their duty to call into question the risk models being used. Here's how Taleb and Triana, experts in risk management, describe things: 'Almost everyone in risk management knew that quantitative methods did not work. Yet a method grounded on those same principles continued to be widely used' (Taleb and Triana 2008). Or perhaps it was the siren song of short-term profits that blinded us. As Chuck Prince, the deposed CEO of Citicorp, infamously noted: 'When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing' (Prince 2007). This was the musical chairs version of capitalism: make hay today and pray that when the music stops someone else is left without a chair, not you. We never considered that there would be no chairs left for anyone.

So the music continued and the game continued, even as the chairs were being taken away. Those issuing a mortgage ('originating' it, to use the jargon) sold it on to someone else. That eliminated the old-fashioned bank manager who gave you a mortgage, and was *responsible* for making sure it got paid back, and *accountable* if it went wrong. Instead, the mortgage broker sold on the loan to someone else, who then packaged it with others and bits of it got sold around the system. In that way everyone took many small bets and, so they thought, reduced their risk. In fact, no one knew what risks they, or the system, were taking. Spreading the risk became, itself, a risk. With everyone responsible for tiny bits of thousands of mortgages, no one was responsible or accountable for any one loan.

Enter the credit rating agencies (CRAs). These are organisations that 'rate' credit. In other words they predict how likely a loan is to default. Now this is a very important role. When the CRAs say something is investment-grade, meaning unlikely to default, companies can issue debt to investors widely and therefore less expensively. There was only one snag. The CRAs got it wrong on subprime mortgages. As home prices fell, it turned out that the CDOs that had been fashioned out of them were not investment-grade after all. That was what triggered the crash in 2007.

Some might argue that the CRAs made an honest mistake. However, the business model of the CRAs is itself suspect, because they get paid by those who are issuing debt, not by those who are investing on the basis of the ratings. So, if it wants to get paid, a CRA has the incentive to give positive credit ratings. This, too, was obvious, and not just in hindsight. The CRAs had already got it wrong in 2001 with Enron and Worldcom. In 2006, we wrote: 'credit rating agencies harbor a fundamental conflict: they are paid by the companies they rate, not by the investors they are supposed to protect' (Davis et al 2006: 146). The same issue was on everyone's mind by 2008. Certainly the CRAs were not producing *independent information*.

These problems were then compounded by the way in which accountants treated the new securities that banks were trading. In the past, the bank would make a loan, say for £100,000 and, subject to some provisions for default, it would hold that loan on its books, at £100,000, until it was repaid. But now packages of loans were being traded in the market. Accountants insisted that each bundle be marked to the market price, because they felt that is what those who traded bank shares would want to know about. That is true. However, as the basis for determining the strength of a bank, 'mark-to-market' accounting is problematic. When the market for these loans is strong, the bank makes a profit, lends more and, incidentally, pays its staff big bonuses. However, if the market for those loans dries up, banks suddenly look insolvent, even if the loans are current in paying their interest, there was little likelihood of a default and a bank intended on keeping that performing loan. Put simply, accounting, was providing information which may have been of interest to those buying and selling bank shares, but it was not providing the *relevant information* on which to judge bank stability.

In this world of limited responsibility and accountability, the culture was one of 'devil take the hindmost' – every man for himself. Incentive structures reflected that culture. Bonuses were paid on year-end profits, where asset values were 'marked-to-market'. And for a few years the bonuses rolled in. But there was little regard for the long-term risks to the institutions concerned, and none to the stability of the system as a whole. To many, the notion of 'responsible investment' was an anathema. The public, the politician and the media looking on may have felt that there was something wrong with the quantum being paid to executives, but they lacked the institutions with vigilance and clout to raise uncomfortable questions and demand answers.

Then the crisis broke. Subprime loans fell precipitously in value, even if that particular CDO was still 'performing', that is, even if it was paying interest on time, and unlikely to default. Strong banks now had to mark down their value, as the accounting rules said. The banks then started to look weak, so depositors began to withdraw funds and put them elsewhere. Government agencies ultimately came to the rescue, but were concerned that they could not be seen to save every bank. If they had, they would be condoning those whose lending had been irresponsible.

So they allowed the collapse of Lehman. That spooked investors. There were runs on the banks, as depositors took their money out. In the UK, there had been a run on Northern Rock in 2007; now there was a run on two of its major banks: HBOS and RBS. Banks had no way to trust the balance sheets of other financial institutions or even industrial companies, and they wanted to conserve their own cash. So lending between banks dried up. This is the lifeblood of the financial system. If banks might not be able to raise cash, companies could no longer assume they had access to cash or credit and so cancelled investments and cut costs. The recession was upon us.

What went wrong? As highlighted in this discussion, it was not just regulation, though it played its part. It was, fundamentally, a chronic and pervasive lack of *responsibility* and *accountability*. It was a failure to produce the *right information*, and a lack of *independence* by those who did. And it was a failure among market parties to exercise the *vigilance* necessary for a complex financial system to work.

The requirements for accountable capitalism

In *The New Capitalists*, we argued that it was possible to build a 'civil economy'; that there was a burgeoning set of institutions that could help embed accountability into the economic system in the same way that political institutions gird democracy in 'civil society'. In that book, we were concerned with the way the 'equities' or 'shares' of companies were managed. For the past 20 years we, and the rest of the 'responsible investment' movement, had focused largely (though not entirely) on equity, not credit. In hundreds of initiatives, national and global, voluntary, enterprising and regulatory, people have been trying to create a 'civil economy' to replace the uncivil economy of the past. However, all capital markets, whether equity, credit, currency or whatever, need to conform to the five principles we spelled out in *The New Capitalists*: accountability; responsibility; relevant information; independent adjudication; and vigilant participants. Let's briefly outline what we mean for each.

Accountability

For each player in the market, we need to be able to answer some simple questions. In whose interests do you work? To whom are you accountable? What alignments or misalignments of interests can affect your performance? Each player in the market must feature governance to compel alignment between its mission and its constituency. And let's be blunt: if it is not so configured, it must be seen as a potential threat to the stability of the capital market, and needs particular oversight.

When you look at capital markets, particularly those in the USA, where the credit crisis began, there are glaring gaps in accountability. For example: US pension plan governing boards do not include representation from retirees or the workers contributing to the plan; the credit rating agencies are paid by issuers, not the investors who rely on the ratings; and the boards of most investment banks in the US did not feature independent chairmen who could effectively oversee the CEOs. In two cases – AIG and Washington Mutual –institutional investors actually mounted pre-crash challenges to that crony culture. But despite the fact that they were supposed to create 'shareholder value', directors rallied and rebuffed the shareowners.

Responsibility

Accountability is the tool that enforces responsibility: each player should actively exercise its rights to optimise the long-term value of its assets on behalf of those for whom it works. An example: shareowners should not only *have* rights to replace corporate board members at troubled companies, they should *use* those rights.

Big investors, particularly big pension funds, have pooled our savings and become the fractional owners, not only of much of the debt that has turned toxic, but of the companies that originated the debt. With such a vast amount of value at stake, one might have thought they would have found ways to defend their interests and hold boards and managers to account, and hence protected the interests of their savers. Most barely tried. Why?

Institutions managing trillions in savings feature long-entrenched habits that suppress their own responsibility and accountability to clients. US mutual funds and UK unit trusts have largely morphed into machines that buy and sell securities. The average American mutual fund turns over more than 100 per cent of its securities every year, which means they are traders rather than long-term investors. They suffer from that peculiar disease of smart people – they are all Chuck Prince, thinking that he can find a chair even when those about him are falling onto the floor. Since they always think they can get out of the way of a disaster at the last minute by trading, they do not worry about trying to prevent disasters by being responsible owners or lenders. Worse, academic studies have revealed that mutual funds may adjust investment tactics as well as voting to attract more corporate business rather than to optimise returns for investors. Mutual fund accountability is dampened further as elections for their own board members are few and far between.

Relevant information

Disclosures should not merely be voluminous, but shaped for real use and addressed directly to value. For example, US regulators set detailed rules companies must follow for releasing data on executive remuneration. But prescriptions largely miss the point of what shareowners actually need and how they use compensation reporting.

More concerning, there are huge areas of the financial markets that are opaque. Look at the 'Credit Default Swap' (CDS) marketplace. A CDS is essentially an insurance policy on whether a company will default on its loan; it is a bit like a life insurance policy on a specific company. Just like a life insurance policy, it has a useful role. However, most people would be quite concerned if they discovered that someone had been buying a life insurance policy on their life, and they did not know who it was. Yet many CDS are bought and sold with no disclosure whatsoever. If you hold a CDS it is in your interest for the company concerned to go bankrupt. Was that a contributory factor to the credit crisis? We just do not know.

There is not just one set of information needed. It is not just that current accounting procedures may be inadequate. A lot of heat has been generated by the debate about 'mark to market' accounting. The relevancy of such an accounting principle depends on the circumstances in which it is going to be applied, and the purpose for which it is going to be used. Certainly it is very dangerous to use such accounting for bank regulation because it is pro-cyclical; it rewards the banks when things are going well but puts a squeeze on them when things go wrong.

Independent information

That markets move on information is well-known; that is why the past decade of reforms have included the forcible divorce of auditors from providing consulting services to the companies they audit, and prohibited stock analysts from being compensated for by investment banking results. Markets need conflict-free intermediaries to serve as a reliable check on corporate information.

Yet the reforms hardly cover the waterfront. As noted, investors, not corporations, should pay for credit reports. But it is not only the CRAs that are open to conflicts; similar potential conflicts may be seen among remuneration consultants (tempted to build CEO-friendly payouts in hopes of gaining other business); director search firms (wary of recommending feisty board candidates for fear of losing other search contracts); and various distribution channels that take fees from asset managers but claim to be doing due diligence on those same asset managers. US Securities and Exchange Commission (SEC) Chairwoman Mary Schapiro declared in an October 2008 speech that such 'individuals have allowed the pursuit of wealth to become mere sport, devoid of any ethical meaning or moral obligation to others' (Schapiro 2008). We wrote in *The New Capitalists* that if the public lost faith in the integrity of these agents, 'the capital markets would seize up' (op. cit.: 123). And that is exactly what happened.

Vigilance

Owners of private sector corporations – be they institutional investors or, more frequently today, governments – need to combine accountability with responsibility and information to deploy skilled watchfulness over company boards. If owners fail to take up that charge, the rest of us must depend on regulators to supervise well enough to ensure market stability. But we do not have enough financial police to do that unless we turn securities markets into virtual garrisons, choking the capital nimbleness nations need to stoke economic growth.

Today, there is consensus on what sort of vigilance long-term shareowners should exercise. They should monitor and, where warranted, engage with portfolio company boards to build frameworks for sustainable performance. But that vigilance does not come naturally. Entrenched habits fostered by conflicts of interest and a hardy culture of passivity have suppressed responsible behavior. One striking example: as the financial crisis hit, investment houses including Deutsche Bank, Citi and JP Morgan moved early to slash their corporate governance analytical units, which are just the sort of 'eyes and ears' investors rely on to patrol the market.

Watchfulness can, however, be nurtured by smart, targeted public policies. The Australian government, for instance, is providing seed money for an investor academy to raise trustee and fund oversight skills. Steps to increase trustee accountability through more thorough reporting requirements can further contribute. Rules can require that job descriptions for fund Chief Investment Officers include skills that involve corporate governance monitoring. And collective fund groups such as the UK's National Association of Pension Funds and Association of British Insurers, or the United States' Council of Institutional Investors, can do more to coordinate joint investor engagement. Perhaps the most potent spur to vigilance, though, might be the rise of grassroots shareowner movements using Web 2.0 social networking tools to pressurise institutional investors into continuous engagement.

The role of regulation: horizontal vs vertical

In the discussion above, we have outlined the simple set of principles that underpin a responsible financial system, and give examples of clear failures where reform is needed. However, moving to an accountable, sustainable capitalism requires rethinking the governance of not just the banks or credit rating agencies or any other entity in the financial system, but of the overall architecture encompassing them.

Each market participant is a link in many chains. For example, the mortgage chain, as noted previously, includes a homeowner who borrows to create a mortgage (link 1) from a mortgage originator such as a bank (link 2) who sells the mortgage to an investment bank for packaging into a mortgage pool (link 3) which is rated by a credit rating agency (link 4) so that it can be sold to a pension fund or other institutional investor (link 5) and so on. That is oversimplified, of course; there could be all manner of intermediaries, but you get the idea.

The cliché that a chain is only as strong as its weakest link is true. But it is also dangerous; it is not the whole picture. Chains can fail not because there is a weak link, but because the links do not work smoothly with each other. If the links do not work with each other – if they do not fit together well, if they are rusted or frozen – then what you have is not a chain, but merely a series of elliptical pieces of metal. That is what happened. There was not a weak link in the chain, yet it failed. Borrowers got what they wanted: cheap and plentiful credit. Mortgage originators got what they wanted: lots of fee-generating origination. Banks got what they wanted: unprecedented numbers of individual mortgages to package and sell, reaping billions in fees. The credit raters got what they wanted: a lucrative new product area that became their single largest profit source. And institutional investors got what they wanted: securities that yielded more than was available elsewhere in the investment grade bond market.

Economists have a term for this type of situation wherein each individual decision seems rational but the whole is crazy: a 'fallacy of composition'. The links kept on strengthening themselves – gorging on cheap credit, originating more and more mortgages, rating more and more structured products – even while the chain itself was in danger of freezing up.

Traditional regulation tries to ensure the health of each link. The theory was that by regulating each link separately, the chain will be strong. As we have seen, that is a fallacy. In this type of 'horizontal' regulation, a regulator focuses on a particular link and issues a set of 'thou shalt' and 'thou shalt not' commands, such as banks needing to have so much in reserve. The health of the system takes second place to the health of each specific link.

Horizontal regulation suffers from two inevitable forces that degrade its effectiveness over time. First, markets evolve quicker than regulators can regulate (for example, credit default swaps were a non-entity a few years ago). Second, such command/control regulation often results in the regulated entities seeking to avoid the regulations so as to gain a competitive advantage over competitors similarly regulated. So, for example, we have seen the banks use devices that allow them to lend more by 'gaming the regulator'; there has been extensive use of off-balance-sheet items, proprietary risk calculation models, and various derivative transactions that have vitiated the intent of bank reserve requirements. And that does not even include the most pervasive way by which credit-originating entities avoided horizontal regulation: they simply refused to be recognised as a bank. Hence the rise of the non-bank financial institution in the 1990s and 2000s.

We propose a new conceptualisation of regulation. Regulation should enhance the robustness of the interaction *between* market participants, as well as the robustness of any particular set of market participants. We should enable the various entities within the system to be accountable to each other and to hold each other responsible. Call it vertical regulation: we are looking not only to keep the links strong, but to provide oil to lubricate the links so that the chain keeps working.

Such a regulatory philosophy also implicitly recognises the power of the marketplace, rather than the power of the regulators. Vertical regulation empowers the market participants as well as the regulators.

What would vertical regulation do? It would look at each link in the chain and ensure that it was responsible and accountable, with requisite independent information and oversight. So it will have corollaries:

1. Enhance disclosure across the system. Transparency is a condition necessary to accountability. Here are a few (necessarily technical) examples of where it could be used.

    a. Mandate that for a financial instrument to be tradable or transferable, it must be registered. Various markets have systems for identifying tradeable instruments, such as the CUSIP (Committee on Uniform Security Identification Procedures) number in the US or the SEDOL (Stock Exchange Daily Official List) identifier in the UK and Ireland. Requiring that any financial instrument to be registered as a condition to allow it to be tradable or transferable would mean its basic characteristics are known, it is traceable, and the size of the market is calculable. This would allow the development of new instruments, but assure market participants and regulators are aware of the size, shape and scope of them before they grow to a size that can affect overall financial stability. (To keep this regulation manageable, it could apply only to those credit instruments of more than a minimal size, say US$25 million.)

    b. Investors, speculators and traders should have to disclose material positions in a company no matter whether those positions are held in stock, options, and contracts for differences or other derivatives, and whether those positions are short or long.

    c. Ask all significant investors to make a statement of investment principles which should include a disclosure on whether they are willing to make investments that may do damage to the system or the real economy as a whole. That, rather than traditional regulation or a ban, will be more effective at eliminating instability caused by the 'shorting' of shares.

2. Regulate power relationships between links, not the outcomes, of those relationships. In so doing, give some amount of deference to those whose capital is at risk.

    a. For example, mandating that US companies feature a UK-style advisory shareowner vote on pay, or allowing shareowners to nominate corporate directors more easily, changes the dynamics and power relationship between shareowners, executives and boards of directors; it does not mandate any specific outcome.

    b. Insist that all the agents in the investment chain declare how they are paid. That includes fund managers, distribution channels, financial engineers, information providers, raters, and so on. Allow agencies to develop which will help consumers understand whether the remuneration is appropriate, and likely to lead the agent to work in the principle's best interest

3. Focus on the functional purpose of each entity, not the legal status. If market participants are 'gaming the regulator', blow the whistle.

    a. For example, the requirements around the issuance of a credit instrument – the extension of credit, and, therefore, the creation of counterparty risk – should be the same if you were a bank, insurance company, hedge fund or non-bank financial institution.

    b. If an asset is 'off balance sheet', but is managed as though it were 'on balance sheet,' it should be treated in the same way. Ditto for banking assets that are held on the banking book and the trading book.

4. Align interests.

    a. This is basic, but remember to align interests across time frames as well as within and between entities. For example, make all executive compensation agreements for executive officers of public companies subject to claw-backs to allow recouping of payment in the event of later restatements or financial distress, after the pay period has passed.

5. Do not allow intermediaries to affect accountability between other entities if they have nothing at risk.

    a. For example, in the US, brokers often vote proxies on behalf of retail shareowners; these so-called 'broker non-votes' are usually cast blindly for management with little thought and less expertise.

6. Where known misalignments of interest persist, there is a threat to the system. It will not be possible to eliminate all conflicts of interest, but where they exist, they should be an urgent area for reform.

    a. Corporate-sponsored retirement savings schemes in the US are nearly all controlled by the issuing company; members typically have no say in defining the nature of the plan or choices available. This can and does produce funds that shun active engagement with portfolio companies, even where such strategies might align with the interests of beneficiaries. One key regulatory antidote would require each such scheme to feature member-selected trustees alongside issuer representatives in an oversight board chaired by an independent outsider. Similar reforms have already been installed in the UK and Australia. Funds around the world should also have to disclose fulsome annual reports to members and regulators on their engagement resources, policies and records.

    b. Another example: credit ratings, by law, affect which instruments various institutional investors may buy. Yet the credit rating agencies are paid by the issuers of the debt, not the purchasers. As we noted in 2006, and as the world unfortunately discovered in 2007 and 2008, this creates an incentive for ratings inflation. It is time for new business models for ratings, such as agencies collectively owned by funds.

7. Always think about the other links in the chain, whether this be in relation to market participants, or in relation to regulatory activity itself.

    a. There is always the difficulty in any market system that participants will suffer 'the tragedy of the commons'. So, for example, they will invest in securities that could yield them a high return, but cause a systemic problem, because they know others will not. Such market participants should be identified and exposed. Their case should be taken to those to whom they are accountable. This requires a knowledgeable and vigilant financial press, as well as informed market participants.

    b. Most regulators will only be successful if they coordinate with other parts of the regulatory system. So, in Britain, the failure of the Financial Services Authority to recognise that the Bank of England was not minded to act as lender of last resort to overstretched banks has contributed to the instability of the system. Had the FSA understood this, perhaps it would have been more conservative in policing the banks' liquidity. Focus needs to be put on how the links in the chain of regulation will work under stress.

We will leave the 'too much' or 'too little' regulation argument to others, though we suspect that combining vertical regulation with horizontal regulation should lead to a more resilient and self-correcting financial system, even while allowing the elimination of some entity-level command-and-control rules. Ideally, vertical regulation will enhance the robustness of the interactions between market participants, rather than the robustness of any particular set of market participants. Regulation should strengthen the game, not determine the winners.

Beyond regulation: vigilance in the capital markets

Regulation alone, however, is not sufficient. Think of it this way: regulation is the societal codification of the rules of the game. As in sports, many rules are subject to interpretation; was the contact incidental or serious enough to be called a violation? Outside enforcement agencies are often the wrong entities to interpret subtleties, for a number of reasons, not the least of which is that regulators often have binary options – something is or is not allowed. Moreover, even the best referees in the world cannot create world-class levels of play. That is only caused by the participants.

By giving tools to market participants to enable them to be vigilant, we seek to enable them to craft reactions that are proportional, quick, and fit for purpose. That should increase accountability, which should increase responsibility, which should spark demand for more accountability tools, and so on, in a virtuous circle.

Clearly those tools are more than regulation, as important as that is. Limiting the discussion to regulation would be akin to saying the only thing that matters in civil society are laws, police and courts, while ignoring a free press, a culture of citizen action, religious institutions, the role of technology and a host of other influences. So, too, an accountable capitalism hinges on the participation of multiple civil economy institutions.

Market-based solutions can be influences for accountable capitalism. CEFEX, the Center for Fiduciary Excellence, has created a certification programme to promote best practice in the investment management industry.[1] More than 50 independent firms have received certifications in the two years since it was established. Hermes Equity Ownership Services (EOS), and Governance for Owners, an independent firm, have created agencies that pool institutional investor resources so as to efficiently engage with managers of corporations.

Non-governmental organisations can play a role, as they do in the political arena. The Aspen Institute has created a network of business school educators around sustainability and cultural issues, with the goal of encouraging values-based education. In our own experience, the UK's Royal Society of Arts is promoting new institutions and citizen awareness of investment choices; the IRRC Institute (Investor Responsibility Research Center Institute for Corporate Responsibility) is sponsoring research and the Yale School of Management's Millstein Center fosters effective, responsible market institutions.[2]

Leadership matters. Warren Buffett has publicised the need for responsible business leadership focused more on creating sustainable wealth and less on short-term get-rich-quick efforts.

Industry groups can be positive drivers of change. The International Corporate Governance Network has historically drawn its strength from institutional investors and has represented them, calling upon corporations to act responsibly. But more recently the ICGN has put increasing resources behind making sure that its members themselves act responsibly, both to those to which they are accountable (the individuals whose savings those institutions invest) and to those they would seek to hold accountable (public corporations), culminating in its issuance of a formal 'Statement of Principles on Institutional Shareholder Responsibilities'. These efforts at promoting responsible investment need to be extended from the management of shares to the management of all securities.

Meanwhile, the Ethisphere Institute and the Business Ethics Leadership Alliance are exploring ethical business standards from a corporate perspective; the coalition includes such global heavyweights as General Electric, Accenture and Pepsico. Put simply, the ethics of business are fundamental to its success. If, when the crisis is over, we have a highly regulated financial system where market participants fail to recognise any broader responsibilities for their actions, we will stifle innovation, and what innovation there is will be directed at subverting the regulation we have passed. We will just have drawn the contours for the next crisis.

All these, and numerous other efforts, promise to have more impact more quickly and more appropriately scaled than will regulation, no matter how well crafted.

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Dealing with the global dimension

One final dimension to solving the credit crisis needs to be mentioned. In our globalised economy, banks operate, and securities are traded, around the globe. A large American or British company may well be financed by a bank from Japan, or a pension fund from the Netherlands. Banks receive capital from sovereign wealth funds in Asia and the Gulf. British depositors had their money in Icelandic banks. German banks were hurt by US sub-prime exposure. French institutions placed billions with Bernard Madoff. So if a new accountable capitalism is to arise, it must do so on a global basis. If it does not, institutions based in one country could continue the destructive short-termist tactic of building up a single link in one country, even if it damages all others. That is precisely what the Icelandic banks did, and why they were able to offer higher interest rates to their depositors than were their domestic competitors. As we have seen, that tactic works for some time, but then leaves everyone – not just the proximate, causal entity – with a mess to clean up.

However, there are two hurdles to creating any international framework: institutional and regulatory. At the present time we have no international institutions that are 'fit for purpose'. Each of the international regulators suffers from a myopic focus on its particular link in the chain, rather than having a panoramic vision of the whole system. The main regulators include the Basel Committee for Banks, International Organization of Securities Commissions (IOSCO) on securities, the International Association of Insurance Supervisors (IAIS) for insurance, the International Forum of Independent Audit Regulators (IFIAR) for audit. Even within these broad areas there are other independent bodies. The International Accounting Standards Board (IASB), for example, is responsible for global reporting standards. No global regulator claims jurisdiction over credit rating agencies, or over institutional investors acting as fiduciaries for others.

There is one body charged with coordinating all these bodies: the Financial Stability Forum (FSF). Its goal is to 'promote international financial stability, improve the functioning of financial markets, and reduce the tendency for financial shocks to propagate from country to country'. It has been around for about ten years, and as recent events have shown, has been about as successful as the League of Nations was, and for similar reasons. First, it is unrepresentative. It offers seats to the four European members of the G7, plus the US and Japan. The BRIC nations (Brazil, Russia, India and China) are not there at all. Second, the forum has no executive powers.

But just as the League of Nations was reborn as the United Nations in 1945, so the Financial Stability Forum needs a new life with a proper mandate. Realistically, that mandate cannot be to become the new unified global regulator. That is both impractical, and politically impossible. Around the world, regulatory structures, even the nature of the law, differ. One size will fit no one, neither substantively nor politically.

In any case, the fundamental message of this paper is that regulation alone will not be enough. Indeed, if anything, the attempt to create global regulations was one of the factors that contributed to the credit crisis. The negotiations for Basle II ended, not with financial stability for banks, but with a settlement that was negotiated as a lowest common denominator. And for all the legitimate enthusiasm for international accounting standards, it is difficult to conclude that the principle of 'decision usefulness' which underpins them, and focuses on the needs of stock market traders, was helpful in encouraging cautious behaviour by banks.

But what an international body can do is to agree to principles. The Organisation for Economic Cooperation and Development took that approach in its widely-praised corporate governance efforts, and those have been widely adopted. A principles-based international entity could be rigorous, not in writing regulations, but in investigating whether those principles are applied in every country.

Here are the simple principles we have outlined in this paper. Even the G20 could surely agree that:

- All actors in the financial system have clear responsibility for the tasks they undertake
- They are in turn accountable, and those to whom they are accountable are qualified and take their responsibility seriously
- Those who make them accountable are provided with relevant information

- Information is provided by independent agents
- All banks and other financial institutions have been 'stress tested', not only for solvency, but also for liquidity
- Civil society, regulatory institutions, and central banking authorities are empowered in a way that can give practical meaning to the above.

We have argued that such principles have corollaries: a preference for transparency in all transactions; clear lines of authority for everyone; coordination among regulators; an end to opaque trading in derivatives; and a concern about OTC (over-the-counter) markets.

They imply new institutions; a lender of last resort for smaller countries, perhaps with an expanded role for the IMF.

They raise questions: over the incentives to credit rating agencies; over the adoption of 'decision usefulness' as the criteria for accounting standards… even over the risk metrics that banks and regulators were using.

Perhaps, then, it is time for a modernised, Bretton Woods-style architecture to repurpose the Financial Stability Forum as a generator of principles for accountable capitalism. For it strikes us that any inspector charged with judging whether the financial markets of the world in 2006 had met those principles would have concluded that many did not. And perhaps, had there been some such an inspectorate, backed by the clout and authority of the G20 group of nations, to tenaciously ensure that these principles were applied, the irresponsible and unaccountable behaviour that was allowed to thrive until 2007 would have been put in check.

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Appendix: Summary of principles and selected reforms mentioned in article

Although it has not been the aim of the paper to offer a comprehensive set of proposals for reform, this table is illustrative of the principles of reform, and of the sort of measures which each principle might suggest.

Principle	Example of reform
Overview	• Five principles agreed as basis for future reform • Financial Stability Forum reconstituted as an 'inspectorate' rather than trying to be global regulator. • All regulators to be charged with 'vertical' responsibility. (Believe their actions to be consistent with systemic stability)
Accountability	• Governance of FSF and other international institutions representative of the global financial community • All fiduciaries exercise governance powers on behalf of principles • No 'hidden' votes • Information available on issues where conflict likely to arise (e.g. remuneration and structures) • Voting on issues where conflict likely to arise (e.g. say on pay)
Responsibility	• All licensed fiduciaries asked to have statement of investment principles, including 'do no harm' clause • Regulation to be based on function, not legal form (e.g. off-balance-sheet finance) • Claw back on pay permitted for failure which comes to light at a later period • Investment fund boards to represent beneficiaries • Reconstitute governance of Credit Rating Agencies to represent users
Relevance of information	• Risk frameworks for regulation are explicit and public • All tradable instruments to be registered • All positions which might give influence, including derivative positions, to be declared • Accounting and other measures relevant for regulatory purposes • Information available on accountability/responsibility issues above
Independence of information	• Ask investment managers to declare CEFEX or similar certification • Governance of CRAs (see above)
Market vigilance	• Establish systematic 'name and shame', as part of hard and soft regulation • Promote industry bodies and others prepared to coordinate fiduciaries and/or give challenge (e.g. RSA in the UK, International Corporate Governance Network globally) • Regulate relationships, to achieve systemic goals