Doughty Centre for Corporate Responsibility

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Hot Topics in Corporate Responsibility

The Financial Crisis: an opportunity for advocates of Corporate Responsibility?

by Chris Marsden

Introduction

Over the last few months there has been a ‘sea change’ in economic thinking across the developed countries. The financial crisis has shown the dominant ‘western’ economic paradigm of the last 30 years to be flawed. The implications of this are much broader than just what we have seen happening in the financial system. They extend to the whole economic system, how companies are governed and the corporate responsibility debate. In effect, the theory that has persuaded many governments to allow companies to do more or less what they want – because an invisible hand will guide markets to efficient outcomes – is both wrong and dangerous. The exponents of corporate responsibility now have a golden opportunity to make the case for more effective governance of company impacts on environmental and social issues.

The first part of this discussion attempts to give a summary of how this dominant interpretation of economic theory failed to prevent, and indeed contributed to, the recent financial crisis. As a way forward, there clearly needs to be more effective regulation of business by our governments – ideally with strong international consensus. But regulation is not the sole panacea – regulators can never hope to keep up with the pace of change of leading businesses, whether financial or otherwise. There are other sources of governance, however, which can keep up and which can make a significant contribution. These are highlighted in the second part of this discussion along with a number of suggested actions. Finally, those who argue that companies should be made to manage their external impacts on society better are urged to make the most of the opportunity created by this change in thinking.

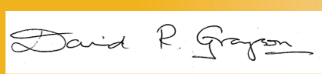
The Author: Chris Marsden

Chris teaches MBA courses on Corporate Responsibility and Business Ethics. He is visiting professor at the International Management School of the Ecole Nationale des Ponts et Chaussées and teaches week long courses in Paris, Abu Dhabi and Leuven. He is Associate Fellow of the Doughty Centre for Corporate Responsibility and teaches on the Cranfield MBA programme in the Sustainable Business elective. He is also a board member of the European Academy of Business in Society, which he was partly responsible for founding. He is Chair of Trustees of the Business and Human Rights Resource Centre and the Institute for Human Rights and Business.

Since gaining an Economics degree at King's College, Cambridge, Chris has worked as a schoolteacher, deputy head, and then joined British Petroleum as Educational Liaison manager before becoming Head of BP's Community Affairs from 1990 to 1996. From 1996 - 1999, he worked at Warwick Business School setting up the Corporate Citizenship Unit. From 2000 to 2007 he chaired the Business Group of Amnesty International UK. He was awarded the OBE in 1989 for services to Industry and Education.

Welcome to the first in our new series of Hot Topics in Corporate Responsibility! We hope to provide you will a quick insight into topical issues that are being debated within the field, to spark thought, debate, and encourage further thinking on important issues. Hot Topics will be written with the aim of generating debate, and we welcome your feedback and thoughts - and even suggestions of other topics to cover in the future.

Professor David Grayson



Director, The Doughty Centre for Corporate Responsibility

The Doughty Centre, part of Cranfield School of Management, with a vision of putting sustainability and responsible at the heart of successful business.

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How a dominant economic paradigm failed

Theoretical principles on which developed countries' economic models are based, as first articulated by Adam Smith in *The Wealth of Nations*, demonstrate the efficacy of markets where buyers and sellers come together in sufficient numbers to ensure free competition and with full knowledge of all the relevant information. Subsequent thinkers have recognised, in addition to these two conditions often not applying, that there were other potential problems not accounted for such as external costs of buyer and seller activity and the issue of public 'goods' and 'bads'. The issue of how to deal with these so-called 'market failures' has formed the basis of much political debate over many years.

Since the Reagan/Thatcher era and the manifest failure of Soviet style central planning, 'western' economics has been dominated by a belief in freeing up markets and de-regulation to encourage enterprise and efficiency in order to create greater value for society as a whole. The financial sector, perhaps above all, was granted this freedom on a world-wide scale during the 1980s and until the recent crisis, all seemed to be going reasonably well. What went wrong?

Most market-orientated economists assumed, and many regulators went along with the idea, that financial markets left to themselves would always tend towards a stable equilibrium that was in the general public's best interest. This is based on two long held economic principles:

- Firstly, the economic actors involved, taking all relevant information into account, will make decisions based on rational expectations, which in aggregate will bring about a stable outcome.
- Secondly, the efficiency of free markets will ensure that prices are correct and reflect market fundamentals.

With the benefit of hindsight, it seems that these economists had got themselves into a position where blind adherence to theoretical principles prevented common sense observation of what was actually happening. There were insufficiently powerful alternative analyses challenging the so-called 'rational expectations' and 'efficient markets' hypotheses. Guiding philosophies are most compelling when they provide clear answers. In this case, accepted theory suggested that financial innovation by well-informed, rational actors would lead to correct prices and market stability and ultimately a safer system. In reality, lobby interests and ideology became intertwined. Deregulation became the policy norm and the CEOs of many financial institutions, based on these reassuring economic models, persuaded themselves and the regulators that they were doing good for all by doing well for themselves.

This predominantly held conventional wisdom meant not only that the chief actors and policy makers thought the system to be a natural producer of outcomes that would be good for everyone, but also that any regulatory intervention should focus on those things that were preventing the creation of these outcomes, rather than recognising that the creation of such an ideal state might simply not exist. Nowhere was this thinking more evident than in the financial sector. Alan Greenspan, Chairman of the US Federal Reserve Board 1987–2006, was perhaps the leading chief actor to propound this view. Yet in a statement to Congress in September 2008 he had to admit that

"Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity – myself especially – are in a state of shocked disbelief. I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works."

The dominant economic thinking underlying the financial system lacks any notion of externalities. The narrowly focused economic incentives of most of the financial institutions, especially as they grew in size, backed up by their immense market power and political influence enabled them to pursue self-interest with total disregard for the costs they might be imposing on the rest of society. In reality imperfect information flows, skewed incentives and unequal relationships between bankers and their clients have led to outcomes highly damaging to the public interest. Excessive profitability and potentially harmful volatility are entirely consistent with individual rationality. The actions of bankers and their bonus-incentivised dealers were entirely rational from a self-interest perspective. There was no thought given to the potential implications of their actions on costs to the general public and ultimate whole system failure. Indeed, if they thought about it at all, they would probably have assumed that what they were doing was in the overall public interest.

The financial crisis has demonstrated that we should reject the idea that free markets can lead to perfect stable outcomes and that we should reject the idea that government intervention could ever help the system to achieve it either.

This was ably described by, among others, Adair Turner, Chairman of the Financial Services Agency at the inaugural conference of the Institute for New Economic Thinking, supported by George Soros, at King's College Cambridge on 10th April 2010 and by Professor Bob Rowthorn at the same college a week later speaking to the Society of King's Economists.

The old, now discredited by many, economic paradigm was also used to support the argument that it was wrong to expect companies to take social or public interest issues into account in their business decision-making because it would be inefficient and damage their wealth creating potential. "*So the question is, do corporate executives, provided they stay within the law, have responsibilities in their business activities other than to make as much money for their stockholders as possible? And my answer to that is, no they do not*" (Milton Friedman). The financial crisis has shown that while the old paradigm may enable huge wealth creation for the few, without better governance it can lead to equally large wealth destruction for the many. That is not to suggest that companies, financial or otherwise, do not have the potential to create valuable wealth for all. Of course they do. Nor is it to suggest that the market mechanism and the freeing up of international trade cannot produce efficient economic outcomes. Of course they can. It is to suggest, however, that we need to work on ways to make the market and companies which operate within it, take account of and be accountable for the wider impact they have on society and, therefore, produce environmentally and socially as well as economically efficient outcomes.

A way forward

At the time of writing it seems that the International Monetary Fund (IMF), supported by many of the richest nations, may be about to introduce greater international regulation of financial institutions. This must be the right way forward as long as it provides incentives to encourage responsible behaviour which prevents risk-taking at the public's expense.

However, will this attempt at more effective governance of the financial sector just end there – or might this be the start of more effective international regulation of any business activity, which impacts on crucial international public interest issues, such as climate change, poverty and human rights? Will it be more than a temporary plugging of the currently identified governance gap, rapidly to fall behind new business practice as regulators fail to keep up with the latest, even more complex developments?

Using the financial sector as an example, policy makers considering how the financial system might serve the public better need to:

- Understand that the system is in effect an unstable network of complex interactions. There is always a risk that the whole system might fail. Future economic analysis needs to encourage more conflicting views and the implications of multiple partial insights as opposed to one dominant ideology.
- Explore more closely the implications of individual rational behaviour on the system as a whole and add into the mix the implications of behaviour that can be instinctive and emotional.
- Understand better how modern, complex markets work and the networks, power relationships and social forces that impact them.
- Accept that all predictions about the future are subject to an inherent, irreducible uncertainty and not the product of some collective set of rational expectations.

The way forward being investigated by the IMF for the financial sector probably will not succeed unless corporate responsibility academics, advocates and activists take full advantage of this window of opportunity to raise their game and strengthen their arguments. Better regulation can never be the sole panacea – regulators simply cannot keep up. Business, leading financial institutions and multi-national companies especially, will always be ahead of the game. In many ways it is in the wider public interest that they should be because they are a major source of wealth creation and technical and economic development. However, they need stronger governance and if formal regulation is unlikely adequately to provide this on its own, we need to highlight and strengthen other less formal governance processes, which governments can do much to encourage, if not directly enforce. Unless this happens, national governments are likely to let things slide. Not only are their hands often tied by international competitive pressures forcing them to restrict the behaviour of their key economic actors as little as possible but also they are highly influenced by powerful lobbyists whose interests lie with the 'old' economic ideology and will do all they can to present the case for carrying on with 'business as usual'.

Actions we can take

The main other sources of governance we now need to strengthen are market forces, civil society pressure and self-governance from companies themselves.

- More needs to be done to influence consumer and investor behaviour to favour environmentally sustainable and socially sound products and services.
- The business case for taking on the costs of environmental and social impact must be strengthened.
- Pressure, especially from campaigning non-government organisations (NGOs), through exposure of bad practice, raises the cost of doing harm by damaging reputations and brand image. Recent law suits being pursued in the 'home' country of multi-nationals concerning abuses carried out elsewhere have also increased the potential cost of litigation as well as reputation damage.
- Meanwhile, those NGOs and CR consultancies which engage with companies in helping them to understand their environmental and social impact and the benefits that can come from their effective management should highlight good practice and enhance the benefits of responsible business behaviour. This can affect companies directly in the market but also indirectly through influencing governments to be more involved.
- The threat of more government interference can be a powerful incentive for companies to raise their game. Improved self-governance from companies themselves is critical, both individually and collectively, through their own codes of ethics and principles and voluntary agreements is another important area to influence. Large companies with their statements of mission and values and smaller companies led by the personal example of their owner-managers all, to some extent, have internal governance procedures which determine how they do business and relate to their stakeholders, including the wider community. Passionate idealists and strong individuals have helped some companies to become leaders in managing their external environmental and social impact. For most, however, although they probably do some good things, for various reasons they fail to manage major parts of that impact effectively. Reasons include perceived competitive pressure, ignorance of what they could do and the costs and benefits involved and generally short term thinking. Maybe the shock of the financial crisis will create more understanding of externalities and long term thinking. Certainly it provides an opportunity to make the case more strongly.

These forms of governance need to be understood better, highlighted and strengthened. They are a not a substitute for effective government regulation but a crucial part of the emerging de facto governance picture, helpful both in the absence of strong government and in providing building blocks towards stronger government. This is the opportunity for corporate responsibility academics, advocates and activists. We should be working to understand better the economic, social and political forces, which are behind the new sources of governance, how they inter-react, how to make them work better and where more formal government intervention is most needed.

This is the agenda for new research, for activists wanting to influence more responsible company behaviour and for business educators wanting to provide analysis of new forms of governance over company behaviour and to prepare business students and existing managers for new ways of thinking. We should seize the opportunity provided by the collapse of the dominant 'western' economic ideology and the subsequent governance failures seen in financial institutions to make the case for more effective governance of all companies and how this might be brought about.

Chris Marsden
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Footnote: The reference to Adair Turner's speech and other conference contributions is http://ineteconomics.org/initiatives/conferences/kings-college/video (We are not responsible for external links and websites beyond our control)

Cranfield School of Management
Cranfield, Bedfordshire, MK43 0AL
Tel: +44 (0)1234 754554
Fax: +44 (0) 1234 754488