Private-Sector *Corruption* Justifies Society's Clawback Demand

BY GEORGE J. VOJTA

CAPITALISM IS UNDER attack and rightly so. Institutionalized shortsightedness, corruption, and greed, particularly in the financial sector, have led to the worst financial crisis since the Great Depression and a sharp deceleration of worldwide economic growth. Worse, trust in the system has been lost.

And yet capitalism, that economic arrangement characterized by private ownership, free markets,

The founder and chairman of the Financial Standards Foundation called for an end to the enrichment of management at the expense of stakeholders in a recent address to RMA's New York Chapter.

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open investment, and a liberal trade regime, remains the most powerful and reliable path for promoting development, creating wealth and jobs, and reducing global poverty. Wholesale rejection of capitalism would squander unprecedented economic progress achieved around the world in recent decades and the future progress on which justice and lasting peace depend.

But the manner in which capitalism has been practiced in recent years must be rejected, and these practices must be reformed to ensure that people everywhere are reliably and equitably served.

Capitalism is chronically prone to boom-bust cycles. In the three decades prior to the Great Depression, accelerating prosperity went over the edge, and corporate and financial malfeasance contributed to the destruction of the U.S. financial system and the onset of the ensuing Depression. Many titans of industry and finance turned out to be ruthless, greedy, and often unethical (or worse).

Comprehensive new regulation and government involvement in the economy resulted. The financial system was restructured into protected silos. Each class of intermediary was restricted to performing specific functions: commercial and thrift banking, investment banking, and insurance. From time to time, direct controls on prices, exchange rates, and interest rates were established. The severity of the new regulatory regime resulted from public and Congressional outrage at the behavior of the private sector and its leaders.

A deviant private sector is a major cause of crises. Today, we can accurately stipulate that corruption in the U.S. private sector is the poisonous root that has contaminated the global economy. How did this happen? Several factors, which initially stimulated change for the better, were pushed too far and severe consequences resulted.

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Loose regulation of nonfinancial enterprises resulted in pervasive fraud and malfeasance such as occurred at Enron and WorldCom. Excessive and uneven deregulation of the U.S. economy and the financial system bankrupted the self-regulation model. After pressing for passage of the Gramm-Leach-Bliley Act of 1999, which granted banking, securities, insurance, and related powers to financial holding companies (FHCs) regulated by the Federal Reserve, the large U.S. insurance companies (save one) and investment banks decided to avoid regulation by the Fed by not becoming FHCs.

Nevertheless, insurance companies entered the banking markets by establishing thrift holding companies, regulated by the Office of Thrift Supervision (OTS). No overall prudential supervision was established initially. Investment banks also entered banking markets through offshore banking vehicles, special-purpose domestic licenses (industrial holding companies and Article XII entities), and off-balance-sheet activities such as loan funds.

The Securities and Exchange Commission (SEC) remained the regulator of investment banks, but had no prudential or comprehensive oversight powers. In 2003, responding to a European Union directive requiring comprehensive supervision of financial conglomerates, the OTS and SEC became "umbrella" supervisors, but the initiative, though politically correct, was cosmetic and ineffective.

Large financial institutions lobbied successfully to avoid regulation of derivatives, hedge funds, private equity funds, and mutual funds. Consequently, a "shadow banking sector" emerged, free of adequate supervision and rife with greed-motivated, inappropriate activity.

Globalization caused markets to integrate and correlate. Systemic oversight and crisis-prevention competencies failed to anticipate the current disastrous condition. Innovation went too far by creating toxic leveraged instruments that resulted in massive losses. Gatekeepers (accountants, lawyers, rating agencies) redefined their missions to emphasize accommodating clients' wishes and sharing the revenue created, eviscerating their critical checks-and-balances role in the system. Traders and dealmakers, supported by trained engineers and other academics ("quants"), took over leadership of the financial industry. They managed the large institutions to become dependent on revenue from principal risk-taking, one-off deals, leverage, and derivatives (hedge-fund type activity).

General management standards, risk management, internal controls, and fiduciary obligations were de-emphasized and often abandoned in this new culture. Compensation levels became obscene, driven by short-term gross revenue results, and this "money culture" corrupted professional behavior. The new "leaders" were lionized and then often sanctioned or convicted for unethical or illegal acts. Boards, directors, and regulators were inept, complicit, or marginalized, left unable or unwilling to properly manage and/or regulate the private sector, particularly with regard to the unprecedentedly large and complex institutions that emerged.

The crippled financial industry has lost public confidence and will now experience massive consolidation. The large independent investment banks have already disappeared through either acquisition or conversion to financial holding companies. Large nonbank entities—American Express, GE Capital, and other insurance companies and securities firms—will likely convert to FHC status. The top three or four financial institutions will grow to $5–10 trillion in direct balance sheet size and control 60–65% of the U.S. market. Profitability will suffer because most of the revenue from complex financial instruments has disappeared. Standard products, probably priced at higher margins, will dominate the markets. Significant innovation will not occur for the foreseeable future. Direct and more intrusive government involvement will continue for many years.

The private sector (starting with me) owes society a tremendous debt. The private sector prospered for many years; then its activity caused the crisis. Economic growth, jobs, pensions, home values, and human dignity have been undermined or destroyed. As global growth has slowed to near zero, poverty has worsened and more people around the world are starving and dying. Society has a legitimate right to demand a clawback from us—starting with me. And the private sector is obligated to respond by committing time, resources, energy, and value to healing and rebuilding our capitalist system.

Enterprises must express contrition, punish miscreants, and visibly commit to honoring their fiduciary role as trustees of the social, physical, financial, and human capital entrusted to them (most of which they did not pay for) and to managing their affairs in such a way that all stakeholders (shareholders, creditors, employees, customers, competitors, suppliers, communities, and the environment) are not harmed, but instead experience visible benefits. The pattern of enriching management at the expense of stakeholders must end. Explicit, formal commitment and transparent accountability for compliance with these standards must be required.

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Managing enterprises in this manner is not just appropriate; it also enhances performance. The way forward will see firms "doing good by doing right." This framework is the only basis for a legitimate, optimistic, and equitable future for a global economy and financial system worthy of trust. ❖

George J. Vojta is chairman and CEO of the Westchester Group in New York. He is also founder and chairman of the Financial Standards Foundation and eStandardsForum Inc., an organization formed to monitor country compliance with best-practice standards. He previously served as president of the Financial Services Forum, an organization formed by 19 of the nation's most prominent diversified financial firms to focus on regulatory legislative and on public policy issues related to the global financial system. Contact him by e-mail at gvojta@estandardsforum.com.