Discussion paper

Restoring Trust in the Financial Markets: Time to Think Sustainably

10th International Sustainability Leadership Symposium 2009
10/11 September 2009
Swiss Re Centre for Global Dialogue, Rüschlikon, Switzerland

the sustainability forum zürich

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Preface

This paper is intended to provide input to the discussions at the forthcoming 10th International Sustainability Leadership Symposium[1]. It explores main reasons for the current economic and financial crisis and, more importantly, ways of preventing or at least reducing the scale of similar dislocations going forward. Our approach is rooted in the notion of sustainability which is applied to financial markets, corporate business models, corporate governance structures and the realm of public policy. The paper reflects the outcome of a series of interviews with respected experts and executives. Our sincere thanks go to:

- **Stine Bosse**, CEO, TrygVesta
- **Bill Emmott**, Independent Writer, Speaker and Consultant, former Chief Editor, The Economist
- **Ernst Fehr**, Professor, Chair of Microeconomics and Experimental Economic Research, University of Zurich
- **Patrick M. Liedtke**, Secretary General and Managing Director, The Geneva Association
- **George Stansfield**, Executive Vice President & Group General Counsel, AXA
- **Peter Voser,** Group CEO, Shell
- **Klaus Wellershoff**, Member of the Board of Directors, Schindler Holding, former Member of the Group Executive Board & Chief Economist, UBS

We hope that this paper shall make an inspiring contribution to preparing and enriching the debates at the Symposium of September 10-11, 2009.

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Chief Executive Officer
The Sustainability Forum Zürich

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1 The opinions reflected in this paper represent individual views of the interviewees quoted. Therefore, this paper is not a statement or declaration by The Sustainability Forum Zürich, nor of its member institutions.

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.

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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.

The build-up of the crisis: 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.

Stine Bosse
CEO, TrygVesta

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 Schumpeter[2]." *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.

Bill Emmott
Former Chief Editor, The Economist

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.

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

The build-up of the crisis: 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."

Ernst Fehr
Professor, University of Zurich

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.

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

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."

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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.

How can stakeholders' trust in the viability of the financial sector be restored? Which measures need to be taken to put the system of 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. In his view, enhancing disclosure has both a qualitative (e.g. in respect of complex structured products) and a quantitative dimension (e.g. in respect of derivatives traded "Over-the-Counter" (OTC)). "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.

George Stansfield
Executive Vice President, Group General Counsel, AXA

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 as such 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."[3]

Peter Voser
Group CEO, Shell

Stansfield sees a specific need for regulatory action in the area of securitisation where the interests of originators and risk takers need to be more properly aligned in order to avoid excesses such as in US subprime lending. *Wellershoff* concurs: "The division of labour between risk originators and absorbers has been driven too far and needs to be revisited." In this specific area the self-regulation forces of the 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. From an insurance perspective, *Stansfield* argues that the notion of marking assets to market is somewhat hard to reconcile with the long-term character of insurance liabilities, a mismatch which can cause major distortions to the insurance industry's financial reporting. He also questions, from a longer-term perspective, the wisdom of exerting political pressure on accounting setters.

3 Stine Bosse has chosen to limit her comments to "The future of finance – towards a sustainable paradigm".

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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 the motivation for growth and this could in the longer term work against an effective asset allocation and market expansion for the financial markets."

Wellershoff 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".

Klaus Wellershoff
Member of the Board of Directors, Schindler Holding

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.

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.

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