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The Current World Financial Crisis and Implications for Managers of the 21^{st} century: The Need for Human Capitalism

by Prof. Nickolaos G. Travlos, Dean
and the Kitty Kyriacopoulos Chair in Finance,
ALBA Graduate Business School, Athens, Greece

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Dear Members of the 2010 Graduation Class,

It is a great honor and pleasure to be the guest speaker of your 2010 Graduation Ceremony. The topic I will cover is the current world financial crisis and implications for managers of the 21^{st} century.

When I was at your age and position, in 1978, the main challenge was the survival of one economic system over the other; that is, capitalism over communism. The fall of the Berlin Wall in 1989 and the collapse of most communist regimes around the world along with the large growth rates of most economies over the last twenty years seemed to point out the winner, at least in the short-run. However, it raised questions about how long the capitalistic system could go unchallenged. Well, the answer came sooner than expected. Indeed, the world financial crisis of 2008, the biggest one after the big crash of the U.S. stock market in 1929, raised serious questions again about the role of the private sector in creating and sustaining social wealth, as well as economic growth and stability. Naturally, the discussion is focused again on the goal of the firm and the role and responsibilities of top managers.

The standard MBA text books suggest that the goal of the firm is the maximization of shareholders' wealth. Having said that, several questions arise. That is, should companies be ethical and socially responsible? Are there any limits to corporate actions towards promoting these two principles? Are there any mechanisms required to effectively implement them? What went wrong, related to these two principles, during the current financial crisis?

Let me first begin with the last question:

The financial crisis was the result of:

(a) Excessive use of securitization
(b) Abusive use of borrowing
(c) Excessive bonuses of CEOs and other top executives, based exclusively on short-term profits
(d) Overrating by bond rating agencies of corporate bonds issued by investment banks to finance securitized loans (subprime debt)
(e) Deregulation of the financial system.

The securitization, which is the sale - for cash - of the portfolio of mortgage loans of a commercial bank to an investment bank, removed the incentive of commercial banks to assess correctly the credit risk of their customers - the mortgage loan recipients. This is the first case of breaking their ethical responsibility by failing to assess and price correctly the credit risk of their original customers. The commercial banks' lack of ethical responsibility was reflected vividly in the infamous NINJA (Non – income, non-jobs, non-assets) loans that were motivated by the generous bonus schemes offered to loan sales personnel which were based solely on originating loans, regardless of their credit risk. This represents the second ethical breach. The third violation of ethical responsibility came with the abusive use of corporate borrowing. While, in general, a debt-to-equity ratio of 9 to 1 is the normal debt structure of a sound commercial bank, several investment banks reached debt-to-equity ratios as high as 50 to 1. The CEOs of such financial institutions were taking excessive risks at the expense of their bondholders. Most likely, they were betting on the assumption that these institutions were too big to fail. Some of them discovered that this assumption was false, e.g. Lehman Brothers, and Wachovia Bank. Some others got into a financial mess, but they were rescued by their government, creating huge losses to creditors, employees and other stakeholders. Were they alone in their unethical behavior? No, they were assisted by the bond rating agencies which rated their bonds highly despite of the excessive risk they were carrying. This reflects the fourth ethical violation. On top of this, the extensive deregulation of the banking system, advocated by the U.S. Federal Reserve Chairman, Dr. Greenspan - a strong believer in the ability of the free market to discipline all involved parties - allowed financial institutions to hide their unethical behavior in off-balance sheet transactions or other affiliated corporate entities, representing the fifth ethical violation.

The above unethical activities represent what we call, in Corporate Finance, wealth transfers from creditors to shareholders and/or top managers. When we teach that the goal of the firm is the maximization of shareholders' wealth, we make the implicit assumption that the interests of the creditors and other stakeholders are not violated. However, the current world financial crisis provides a clear demonstration that certain irresponsible and unethical behaviors on the part of the CEOs, representing in most cases their own interests and/or the interests of shareholders, do hurt creditors and other stakeholders and threaten the world economy. Thus, the moral is that companies, under certain conditions, do pursue unethical activities and such activities have detrimental consequences for the entire economy and society. The implication of this analysis is that companies must behave ethically. To that effect, I am proposing that business ethics and corporate social responsibility are two principles which represent necessary conditions for creating and sustaining corporate wealth and social welfare.

Hence, for capitalism to survive, we must enrich it with the institutions and activities which will give it a human face. The capitalism of the 21st century must have a different nature from the capitalism of the previous centuries. In the absence of the antithesis, represented by communism, and in the presence of social injustice, inequities and inequalities, poverty, exploitation, corruptive and abusive behavior of governments and corporations across various countries and continents, I propose what I call "Human Capitalism". This is capitalism where the pursuit of corporate social responsibility and business ethics represents the roots of our educational system, personal, corporate, and government actions.

Regarding corporate social responsibility allow me to point out that any company is a member of a community. It is a great mistake to believe that companies can survive in societies which suffer economic and social failures. Although some opportunities will always exist for some companies - especially multinationals – to relocate, the well being of most national companies is a direct reflection of the well being of the society where they operate. It is, therefore, to their long-term benefit to contribute to the well being of the society by allocating part of their profits to corporate social responsibility activities. Of course, we all recognize the limits of such activities. If, for example, only one company in the industry is ethical and socially responsible, the other companies will gain competitive advantage which will drive the first one out of the industry. If all companies in the industry, or in the country, agree or are forced to be ethical and socially responsible, while companies in the neighboring countries do not follow such policies, then the country loses its competitiveness at the gain of the other countries. It is for this reason that altruistic activities of a few companies, industries or countries cannot reach a sustainable equilibrium. In the "Human Capitalism" that I am proposing, I call for an initiative towards an agreement at an international level, such as the e.g. U.N. or Congress of Developed

Economics, according to which companies will be ethical and will contribute a small fraction of their after tax profits towards an international fund which will fund corporate social responsibility activities across countries, especially in the less developed and exploited ones.

The benefit of this proposal is that it affects all companies in all countries proportionally to their profits, without violating the shareholders' wealth maximization principle. It does not create free rider problems, nor does it affect the relative competitive position of companies, industries and countries. It does, however, need the collaboration of a large number of countries, in a manner similar to the one needed for the international agreement on emission standards. I suggest that the need to address the economic inequalities and poverty across nations is as important and urgent as the environmental issues and I urge that we equally address these issues. The role of the top managers of this century is to educate and persuade shareholders to be ethical and accept giving away part of their companies' profits for charity purposes.

In an attempt to quantify my proposal, I have looked at the after tax corporate profits in 2008 of the 57 countries followed by the IMD. The total reported profits amount to USD 7,1 trillion. A small contribution, 2%, of these profits represent USD 141 billion which could be sufficient to feed, house, educate, and provide health coverage to millions of unprivileged people around the globe.

Graduating class of 2010, regardless of how you feel about my proposal, the fact is that your generation will have to work hard in order to improve and guard the capitalistic system. Capitalism has contributed to the well being of our societies. It has created, however, serious problems and it has more to offer if you craft its strengths and eliminate its weaknesses.

Personally, I am confident that the system can come out stronger from the current crisis. I also believe that your generation is better equipped, than the one I represent, to solve long lasting social problems and to further improve both the creation and equal distribution of corporate wealth and social well being.

Congratulations and Good Luck.