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Trust Meltdown II

The Financial Industry Needs a Fundamental Restart

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INNOVATIO Publishing Ltd.

Beirut Boston Pretoria Tianjin Zurich

Cover Artwork: Malte Lück

Special thanks to and Dr. Christian Kolmer and Racheline Maltese
for editing this volume

ISBN: 978-3-906501-19-2

Content:

Introduction
by Roland Schatz

Everybody in the financial sector expected 2009 to be rough; the headlines following the Lehman collapse were frank. But, at the same time, the chief executives of the finance sector speculated the media would calm down in 2010 as better results proved that Wall Street was no longer losing money.

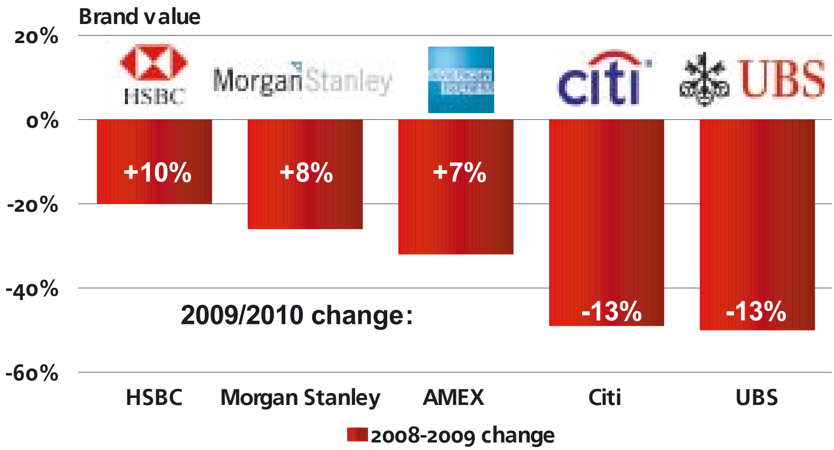
Now, in 2011, the picture is clear: yes, the financial results presented in 2010 were much better than expected. Yet the headlines remained the same. From a reputational standpoint there has been no recovery as the media on Wall Street and Main Street keep asking the same questions: what have you learned from the crisis? And what was implemented in 2009 and 2010 to make sure another meltdown will not happen?

The first Trust Meltdown report made it clear that the banking industry had not caught a mere cold, as much as it had been hit by a fundamental crisis that raised questions regarding its license to operate. Making money out of money was no longer a convincing story for the opinion-leading media. The bottom line in 2009: the media reputation of the finance sector has gone south, so much so, that it was ranked worse than the tobacco industry.

Did 2010 help it to improve? No, the media reputation actually worsened even while the pure economic figures improved. Obviously, Wall Street's hope in this regard turned out to be counterproductive. And hiding away was no solution. Neither was trying to play the blame game that pretended that 'sub-prime' had been a natural catastrophe. The only nature to be blamed here is the nature of mankind; it is human nature to do less good when no control mechanisms are in place.

No company can exist for two consecutive years reporting that its own business, products, and, above all, its management are time and again associated with massive accusations from the judiciary, politics and society: correspondingly, the ratings recorded by Interbrand for selected financial institutions all point towards the negative.   This development was particularly shocking for Citibank or UBS which, after the halving of their brand value in 2009, now also had to suffer a further loss of 13% in 2010. Others such as HSBC or Morgan Stanley had, in particular, learnt their lessons from their communication mistakes in 2008 and 2009, and in 2010 were rewarded with a balanced media image. This also paid off in the brand value index: although the

Chart 1: Global Brand Value 2009 - 2010



Source: Interbrand, Best Global Brands, http://www.interbrand.com/de/best-global-brands/Best-Global-Brands-2010.asp; http://www.interbrand.com/de/best-global-brands/best-global-brands-2008/best-global-brands-2009.aspx

losses from the prior year could not yet be compensated for, the trend was at least upwards.

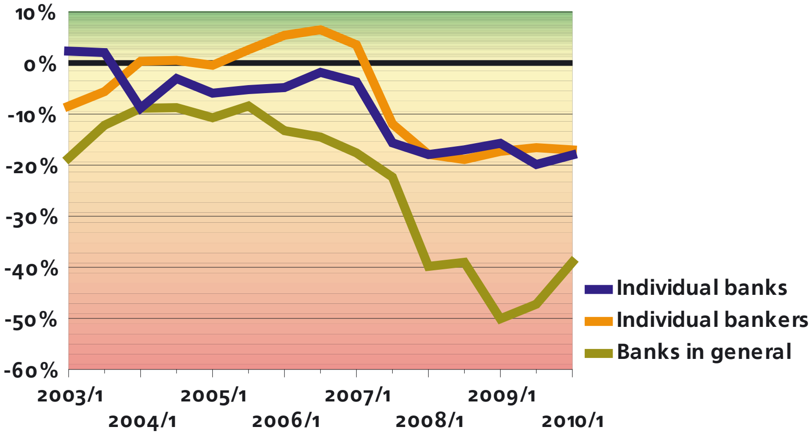
Similarly to the tobacco industry, the banks, with their communication behaviour prior to and in particular after the financial crisis in autumn 2008, manoeuvred themselves into a position which made individual differentiation difficult. The fundamental loss of reputation became less due to the images from the respective hearings in Washington, London or Berlin in which the banks' directors were optically perceived similarly to those accused in the tobacco industry. Far more fatal for the entire industry was the lack of clear communication by the individual banks regarding the repeatedly posed questions:

1. Why did you portray the products as being secure when you must have and could have known in advance that they did not comply with the usual requirements?
2. What have you done to prevent this in the future?

The answers which were given in 2009 were already then rejected as unconvincing by the opinion-leading media. The tactic employed by those responsible of not learning the lessons from this in the following 12 months, and instead convincing the sceptics through repetition, may have worked in the 20th century. However, in the wake of Enron etc., as well as the experiences from the unforgettable value-destroying machine, the internet bubble, in which the banks also played their part in the first instance, it no longer works to replace sound argument with good clothes and expensive appearances. The chart below spells out the unchanged destructive result: concrete banks and concrete bank directors are, on average, negatively presented in the opinion-leading media – but if the same media mention "banker" the criticism doubles: every second statement is negative, even though the actual business data were again positive in 2010 – from Citi through to UBS. The fundamental rejection of the financial institutions and their representatives can clearly no longer be justified by saying that the people were dissatisfied with their financial performance. Goldman Sachs or Deutsche Bank are earning money again but the wording of the headline by the FINANCIAL TIMES on GS "The bank we love to hate most" was not dictated by the mood of just one day.

This is not just due to the conduct of bank representatives since the banking crisis. The information on their

Chart 2: Individual Banks and the Banking Industry in Comparison, Tone of Coverage 2003-2010



Basis: 50,081 reports (at least 5 lines/seconds) in 21/29 German TV and print media actual business also did not improve and the products remain untrusted. Even though the banks may themselves be under the impression that their customers are "satisfied" , they derive this "satisfaction" solely from the fact that their customers have not closed their accounts. This, however, appears to be more for a lack of alternatives than consensus amongst banks' customers, taking into account the fact that they are getting an interest rate of maybe 3% or 4% from their bank for keeping their money at their bank - in some regions it remains unchanged at less than 2% - while the banks' top management are themselves again talking about profits of over the 20% mark in the media.

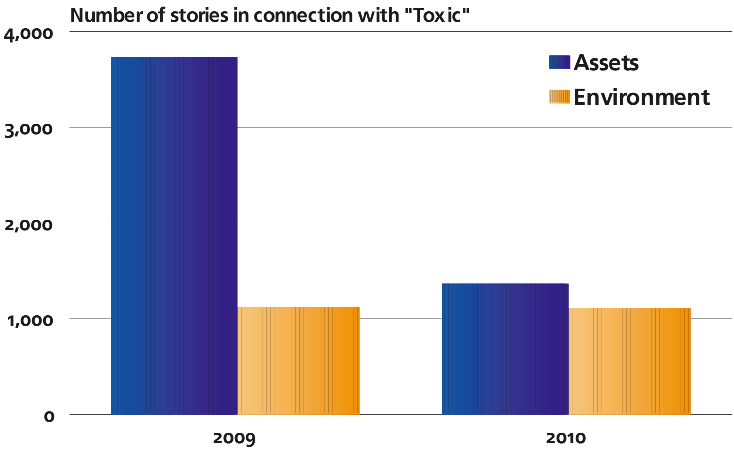
In an interview on the 8th of October 2010, the former soccer player Eric Cantona in passing remarked "3 million protesters on the streets means nothing, but if these 3 million people would withdraw their money from the banks – that type of action would have some consequences". The interview was published in the context of the riots in France. The Belgian screenwriter, Géraldine Feuillien, and a 24 year old actor, Yann Sarfati, then launched the campaign "Bankrun 2010" (www.bankrun.com) as well as the Facebook page "Stop Banque" through which, on the 7th of December 2010, they called for the public to withdraw their money from the banks. 33,000 French nationals publicly supported this campaign within 4 weeks. On the day itself, of course, little happened because the initiators had neglected to offer an alternative. This example, however, illustrates the explosive mood amongst the banks' customers.

Reporting on the products of banks – and partly also of insurance companies - has in any case not stopped since the Lehman collapse. In principle, not one week passes by without warnings against the "life insurance" product. Although these voices had already come to be more vociferous in the 90s, the intensity with which one of the cornerstones of people's contact with the financial world was being questioned took on a new quality in 2010. All the more so as this product, contrary to the purchase of a car or a computer, is solely based on a customer's trust in the credibility of the offerer: year after year customers keep on giving their money to a partner without getting something in return in order to hopefully receive more in total after some decades. Telling customers month after month in large letters (except by insurance companies and the banks who sell their products) that this, in principle, is not a good product, does not promote trust. In particular not in a context where people are now also being confronted with the term "toxic" in relation to products from the banking sector, a term which they only know from their experiences with environmental disasters. The chart below illustrates the connection in which the word "toxic" appears together with bank products in the Financial Times, Wall Street Journal and Barrons. Even though the intensity diminished during 2010, it remains striking that, even in 2010 still, the elite of the financial media used the term more frequently in connection with products in the financial industry than with products in the chemical, food or pharmaceutical industries.

Just as the media reporting on banks in general reflected, for instance, on the brand value of the various institutions, so the impact of a disastrous media reputation on their products was tangible: the flight to other assets such as gold or silver drove their prices to new record highs in 2010. Regional institutions experienced growth rates never seen before. Banks such as the GSL Bank doubled the money entrusted to them in a short time solely because they gave their customers the assurance that they would not act like Deutsche Bank or the representatives of Wall Street.

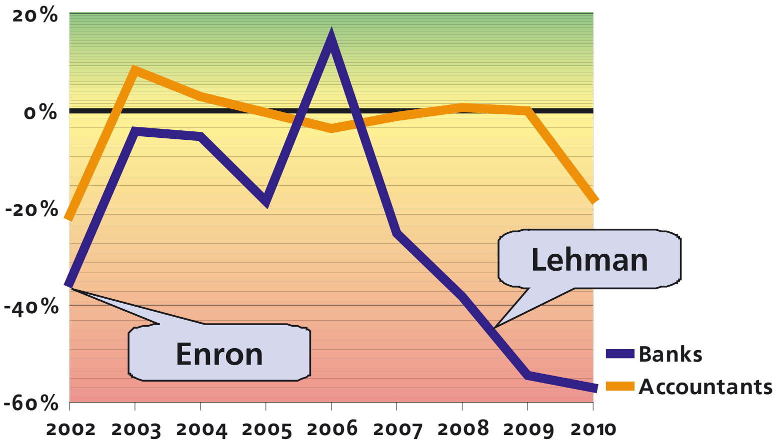
At the same time, complaints against individual bank representatives increased in both America and Europe:

Chart 3: Connotation of the Word "Toxic" 2009/2010



Source: Ft, Wsj (print & online), Barron's, text search

Chart 4: Evaluation of Banks and Accountants in US Media, 2002-2010



Source: 41,153 reports (at least 5 lines/seconds) in 5 US TV and print media

people were no longer prepared to simply return to business as usual and write off their losses while reading on a daily basis that bank representatives were again paying themselves bonuses.

And, together with the banks, another industry was coming under close scrutiny – the auditors. Their hopes for better conduct towards the public did not pay off – what had already been indicated in Trust Meltdown I became ever clearer in 2010: whether PWC or Ernst & Young, their media reputation dropped dramatically in the past 12 months.

For this reason, Trust Meltdown II, after continuing the trend data on reputation, turns its focus to answering the question as to what extent the financial world used the year 2010 in order to implement the improvements required since the 70s in respect of accounting as well as transparency. But even here the potential of all the participants remains virtually untapped: Chapter 2 shows that although the one-reporting initiative was able to make clear progress (behind this is an attempt to numerically record more than just material values on the balance sheet), the requirements for annual and quarterly reports are still far removed from reflecting at least 50% of the value of a company.

As long as nothing changes in respect of this fundamental wrong, banks will continue to make their decisions based on only slightly relevant data and auditors will (not) audit their profitability, even though relevant criteria such as the duration and quality of customer contracts, the relevance of new products and the quality of employees, etc are absent. And yet, these are the value drivers – not the number of company cars, the 30% paid off computer or the interest expense for loans of the 75th subsidiary. This is approximately equivalent to a patient whom a doctor diagnoses as being healthy or as having cancer based solely on measuring his blood pressure and listening to his chest. Everyone would change his doctor – but which bank and which auditor can companies turn to to have the full value of their activities audited if they themselves do not have the know-how or the willingness to record the overall values?

Trust Meltdown II highlights the trends and offers solutions on how to regain trust, starting with no longer hiding from the media and working to improve accounting standards. Without transparency, the industry's license to operate is at risk.

1. Reputation: The Trust Meltdown Continues

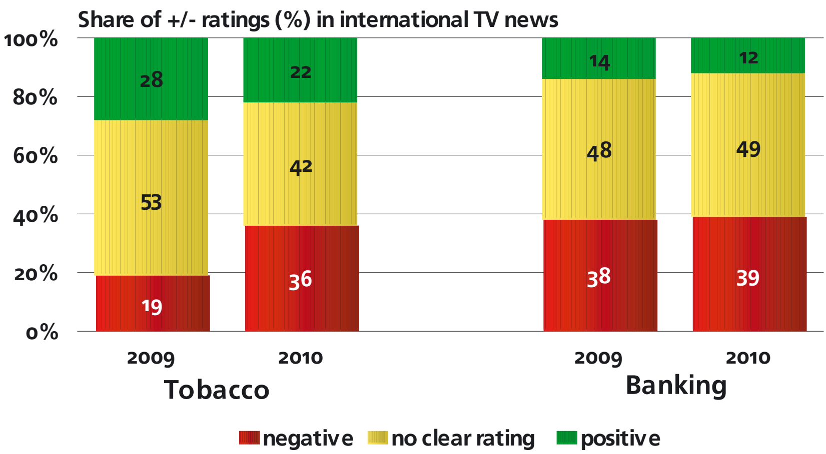
1.1. The Financial Industry Continues to Ignore the Need for Reliable Answers

by Roland Schatz

All the Devils Are Here is the title of one of many books which have made headlines since the collapse of Bear Stearns, the insolvency of Leh-man Brothers and the ensuing assistance by taxpayers to countless financial institutions in America, Europe and the rest of the world. *Monkey Business* was a second one, *Liar's Poker* a third and *Casino Capitalism* a fourth in an unending chain of attempts to make the actions of bankers comprehensible. The authors are not tabloid journalists, but employees or experts from science and financial journalism.

The trust meltdown regards the financial world reached a new level. However, just a few bankers noticed this: even in 2010, most of the CEOs in hearings put forward the thesis that the subprime crisis had been an "accident" which nobody could have foreseen and which, in principle, similar to a tsunami, "had simply engulfed the financial world" like the destructive waves which destroyed the Asian coastline in 2005. Nobody could have foreseen this. Even more fatal were the headlines after the hearings in which those responsible for the financial disaster were quoted

Chart 1: Rating of Tobacco and Banking Companies in international TV News 2009/2010



Basis: 107,160 reports in 40 international TV news programs as saying that, in principle, no one did anything wrong.

In Trust Meltdown I, it was clearly argued that this view of things was only advocated by certain bankers and that the reports in the media worldwide evaluated and judged the events differently: the reputation of the financial industry, already in the first year after the bank collapses, plummeted to the level of the tobacco industry, an industry on which any newspaper is allowed to write that its products are harmful to the health of consumers. Nothing changed in 2010 in this regard. Quite to the contrary: not least due to the lack of self-assessment and the obvious inability for self-criticism, banks are now rated even lower compared than the tobacco industry.

ticularly fatal as banks themselves could have clearly presented better figures in 2010. This development was, of course, also reported on in the opinion-leading media.Despite this, nothing changed in the evaluation of the industry. Reports in 2010 dealing with management mistakes as well as banks' lack of willingness to address issues increase further. Criticism of top management became more vociferous quarter after quarter because they continued to refuse to actually investigate the real reasons for the loss of money entrusted to them, something which hardly seems likely to prevent a repeat of these mistakes.

If in the first Trust Meltdown Book, the casino metaphor was viewed as a journalistic exaggeration to be taken seriously, then, when it comes to this similarly-titled sequel, that lenient view is no longer tenable for one of the most respected economic researchers, Prof. Hans-Werner Sinn. The comparison of an entire industry to an irresponsible gambler who would not even take responsibility for the sequences of his actions is now firmly imprinted in people's minds.

Media impact research tells us that such impressions – in particular if they continue unchallenged over a period of more than one year – are difficult to correct. The CEO of Deutsche Bank, Josef Ackermann, (always selected as one of the best amongst its own ranks) might assess this best. Long before the banking crisis, he had to answer to the court in Dusseldorf for a decision customary in the financial world. It is not just the photo of the Swiss-born CEO sporting the victory sign, which was meant in fun, that will haunt the banker until his retirement. All of the participants in those proceedings did not want to read the writing on the wall that, in a functioning democracy, no group is exempted from the norms of society.

It changes nothing in people's perceptions that Ackermann was able to "buy" his way out of the judgement with an amount in the millions; the CEO of Deutsche Bank will no longer be able to reach the acceptance level of one of his predecessors, Dr. Alfred Herrhausen, despite his multifaceted commitment. One photo is already in place for when the media acknowledge his departure after a 50-year professional career:

In the second year after the Lehman bankruptcy and the largest bank bailout in financial history, the financial world, including stock exchanges, did little to contribute to changing these headlines. Even though most were no longer showing losses for 2009 in 2010, and some had also repaid the tex monies with interest, the same accusations in connection with the subsequent problems (now on the part of countries with low and extremely irresponsibly managed resources that have dried up due to the bailout) dominated the media. Instead of finally seeing themselves as part of society and conducting themselves in an appropriate manner, these same financial institutions that would have filed for insolvency in 2008 had citizens not come to their rescue, got caught out yet again in 2009 and 2010 as they had profit maximization on the agenda at the cost of a part in the community of states. That this was partly done using the monies of those who had just a few months previously saved their workplaces, was appropriately picked up by the media. The run on individual banks was introduced in Trust Meltdown I – and in 2010 became reality.

A small ancillary aspect was revealing: an acronym defined by the banking world in 2009 for various states in Europe which had potential or real payment difficulties – PIIGS. This was possibly intended to be a derivation from the readily formulated BRIC neologism coined by a Goldman Sachs expert for the four emerging economic powers of Brazil, Russia, India and China. But, after the taxpayers in Portugal, Ireland, Italy, Greece and Spain had paid their contribution in 2008 ensuring that the supposedly creative neologists could carry on with their business, the neologism proved to be telling in more ways than one. To officially describe an entire nation as "pigs" reveals the character of the neologist as well as that of the user. GISIP or SIGIP would also have been conceivable as a letter combination if the creatives had been solely concerned with an abbreviation for the now risky European states. However, it was no accident that PIIGS was chosen.

It makes it clear from the outset that the bankers, now bankrupt thanks to meaningless speculations, again saw themselves as something better directly after their rescue by the taxpayers. In the very second that the acronym PIIGS tripped off the tongue of a Barclays Bank employee, who was, cynically, believed to have previously earned his money at Lehman Brothers, it was clear to journalists that absolutely nothing had been understood by the banks. Likewise, it could also be assumed that almost none of the promised new safety mechanisms to prevent the next bank insolvency would work, because, apparently, it wasn't just the top executives of Wall Street who had tried to explain their actions that had no sense of responsibility, but their staffs as well. Without this, no turnaround in people's behavior can be expected. Middle management is responsible for product development, rarely top management.

This is alarming for one reason in particular: no journalist seriously assumes that his text can actually effect fundamental changes. Only once this text is read and its view shared by several media, is hope born.
And, in the context of Wall Street's meltdown, the reports were in sync throughout the world. It was then indeed surprising that, despite this, in most of the same banks almost the same conduct was continued by the same people. Particularly as, in the interim, countless specialist books were complementing the headlines and, in 200, 300, 400 or 450 pages, as in *Im Freien Fall – Vom Versagen der Märkte zur Neuordnung der Weltwirtschaft* by Nobel prize laureate Joseph Stiglitz, in principle revoked licences to operate due to the statements made by Wall Street offenders to the tribunals in Washington:

1. "Yes, they knew what they were doing,"
2. "Yes, they were warned by experts several times,"
3. "Yes, it was clear to them that the products which they bought could not work."

Everywhere, in the aftermath of such a finding, at least the top management of the respective organizations changed. The current developments in Tunisia show that even in the aftermath of the expulsion of a dictator who ran the affairs of his country into ruin, people expect not only the tyrant and his family to stop down, but also, during the subsequent period, painstakingly ensure that his employees do not reappear in government under another title; they must also step down. In the aftermath of the worldwide banking collapse, this was not evident. Here and there a CEO had to step down, the first are now in prison, but a change in the responsible staff did not, in principle, take place anywhere.

And that happened despite hardly a day passing in which people did not read in their media that the controlling bodies did not believe the protestations of Wall Street Managers and imposed significant penalties: the British financial regulator, FSA, decreed that Barclays pay a fine of GBP 7.7 million as well as damages of GBP 59 million to the victims of their incorrect advice. Barclays sold products to the insurer, AVIVA, without giving buyers the correct information regarding the risks of these two funds.

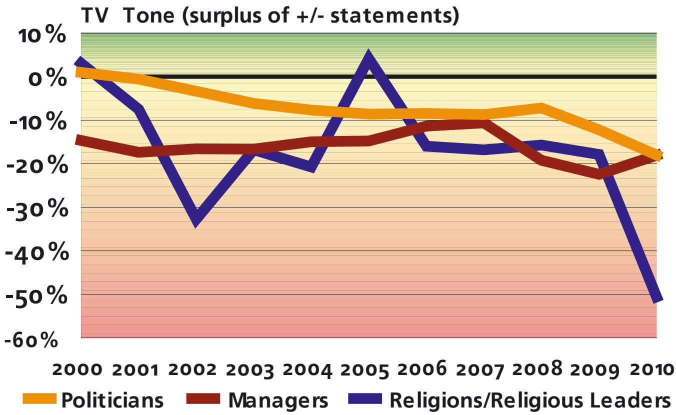
UBS, whose old and new top management made headlines in 2010 with statements that they, in principle, had no knowledge of what they had done. (What CEO of a pharmaceutical company would be left in office by his administrative board or the government if one of his products caused massive damage and he declared publicly that he could not have known that its composition and production might prove harmful?)

They were fined by stock exchange regulators in ZUrich on January 14, 2011, because they had violated the publicity regulations of the stock exchange previously in 2007. Why did it take so long before the stock exchange finally had the courage to call the proverbial spade a spade? The shareholders of UBS refused to approve the actions of the board for their 2007 annual report – and, despite this, the old and the new management of UBS believed that they could save themselves over time with excuses. Even the new chairman of the board, Kaspar Villiger, as a former entrepreneur and former member of the Swiss government, was not only highly knowledgeable in the matter but fundamentally also independent in the audit of the company documents, on joining UBS, ultimately had to bear the headlines that he was not delivering the transparency he had promised. His predecessor, Peter Kurer, in an interview with Nzz am Sonntag even went as far as to say that, in the context of the information demands made of him by experts, the then CEO Marcel Rohner and the rest of the management, it amounted to "lynch justice in a subtle form." With the current judgement by the Swiss stock exchange, according to a statement by the commercial lawyer, Daniel Fischer, the way is now clear for an independent body to institute misfeasance proceedings – in particular as the formal approval of the board for 2007 is still pending. At the head of UBS then was Marcel Rohner, who took over from Peter Wuffli in July in a cloak-and-dagger operation. This event led to massive headlines then. UBS's corporate customers experienced in 2007 that 9 out of 10 transfers were not carried out by UBS although the amounts were actually shown in their accounts. The chairman of the board was Marcel Ospel, who, similarly to Peter Kurer later, expressed his lack of understanding in response to questions by shareholders, customers and the company and, until 2011, acted as if he and his team had done everything right. But, contrary to their protestations of not having known anything – and contrary to the newspaper reports in WSJ, FT, etc., in which warnings of the massive risks of the subprime business had been sounding since 2001 - the Swiss stock exchange, after auditing the documents, came to the obvious conclusion that the decisive bodies already knew of the massive valuation losses caused by the effects of the mortgage crisis in the US at the end of July/beginning of August 2007. This, as a consequence must, of course, have had a significant effect on the overall result of the bank. Its own shareholders, and of course the market, would have had to be informed immediately. Instead, the team around Marcel Ospel and Marcel Rohner on 14 August 2007 believed rather in announcing a record result for the second quarter – without mentioning the known risks. That UBS at that time disclosed the loss of CHF 229 million from its DRCM hedge fund indicated that their knowledge of the rule of the duty of disclosure remained unchanged. Why they nevertheless kept the significantly higher risk of their subprime involvement secret, only announcing a general profit warning for the 3rd quarter on October 1, 2007, will have to be explained to the independent bodies in Switzerland and the US by all those responsible during the course of 2011.

As UBS and the conduct of its top management are not isolated cases, it is in the nature of the observer – even if not directly affected by the banks' conduct – that no new trust can be born in year two after the disaster. After all, all people are ultimately the victims several times over: as taxpayers they (without being asked) had to make their contribution to ensure that an industry was rescued from bankruptcy without being held accountable. An industry which basically owns no product in the actual sense of the word and consequently, since its establishment, remains liable to prove a service comparable to that of the automobile, pharmaceutical, or IT industry. These tax monies are now no longer available for the education of their children, necessary investments in infrastructure, etc. The fact that in Germany the term "no alternative," used by Angela Merkel when speaking about the various so-called "emergency parachutes," was chosen as the misnomer of 2010, gives an idea as to how citizens would have voted if a referendum had taken place in 2008 to vote for or against the no-consequences rescue of the banks, and then again in 2010 regarding the support activities for highly indebted countries. But people pay the price not only for the conduct of bankers through the support actions of their governments, to which they did not give their agreement, but, as a matter of course, also receive less interest for the money that they have lying in the accounts of their banks. This does not remain without its consequences: the doubt of people in their elites is growing.

There is almost no sector of society from which people on average receive trust-building information regarding the conduct of its leaders. 2010 revealed not only the continuous violation of the Maastricht Treaty by almost all European governments, and thereby the non-existent control by the supervisory bodies in Brussels, but the schools and churches also made headlines for their misconduct towards innocent children. Doubt dominates in such a climate. And for the banks, more impor-

Chart 2: Long-term Trends: Politicians, Managers and Religion Tone of TV coverage, 2000-2010



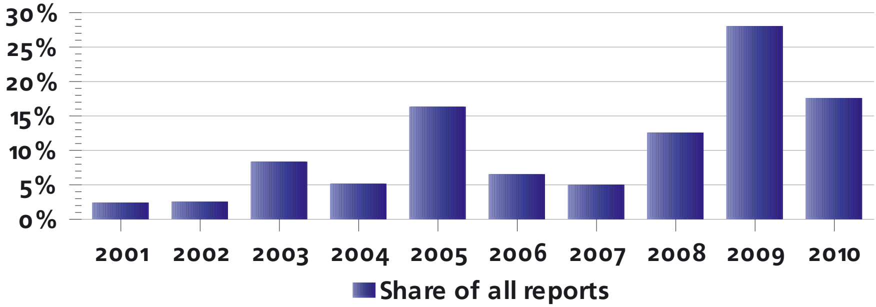
Basis: 110,705 stories on politicians, 25,416 reports about managers, 10,095 stories about religions/rel. leaders in German, UK and US TV news tantly, the willingness to forgive is not promoted as there is no longer any other leadership group which can credibly stand as an advocate for Wall Street. Governments have again lost the short term credit they had acquired in 2008 by not claiming the consequences at the latest in 2010. Religious leaders are concerned with themselves, and researchers, two years after the collapse of the financial system, are unable to come up with ideas which would exclude a repeat of that which is not predictable.

For the banks, the problem is exacerbated by the fact that 2010 continued to keep finances at the center of reporting due to the serious crises in Greece and Ireland. People had to read and see that the banks were accused of trying to make money from the weakening of the euro. For people on the other side of Wall Street and the other financial centres it is not a question of products or market conduct. For them, contributions in the newspapers or interviews, such as with Stéphane Garelli, professor at the IMD in Lausanne and long-time WEF manager, on the "currency war" read very simply: "We have given the banks the shirts off our backs so that the financial system will supposedly not collapse. Two years after the horror stories, we are still seeing no indications as to whether the threats of falling back into a Great Depression were justified or not. We know that our children are no longer receiving the same standard of education in the schools that they did at the time when our tax monies went to the banks. Still, we read that these bankers, who would be unemployed if it weren't for our money, are again paying themselves bonuses, such as the Credit Suisse boss Brady who has no ethical problems in having CHF 70.9 million paid out to him, and are now under suspicion of weakening our currency." No politician will be able to constructively argue against such a perception - and lose his position. The increase in extreme parties was announced in Trust Meltdown I – in 2010 this became a reality not only in the European elections.

Increasingly, the system question is being asked and the answers, which would have had to be given at least in the opinion-leading media, also do not advocate for an improved climate in favor of banks. Using the example of Germany, the chart shows how, in connection with the crises, the escalation becomes ever greater in the opinion-leading media.

Initially, the intensity of the reporting in the financial system increases:

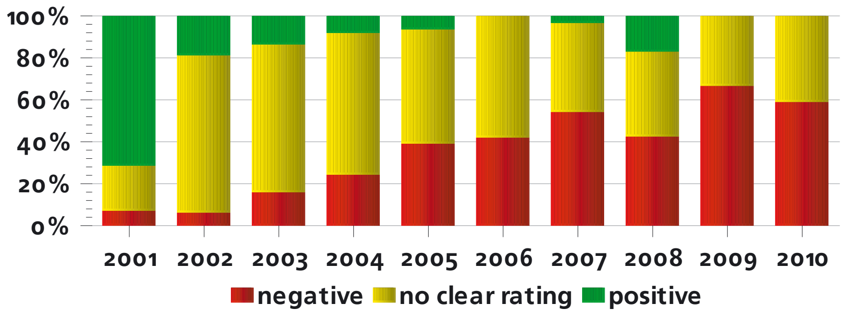
Chart 3: Salience of the "Social Market Economy" in the Values Coverage, German ARD and ZDF News Shows, 2001-2010



Basis: 6,480 reports about the situation in Germany with regard to political values

Then, the actual value of the system is questioned ever more extremely due to shocking individual cases:

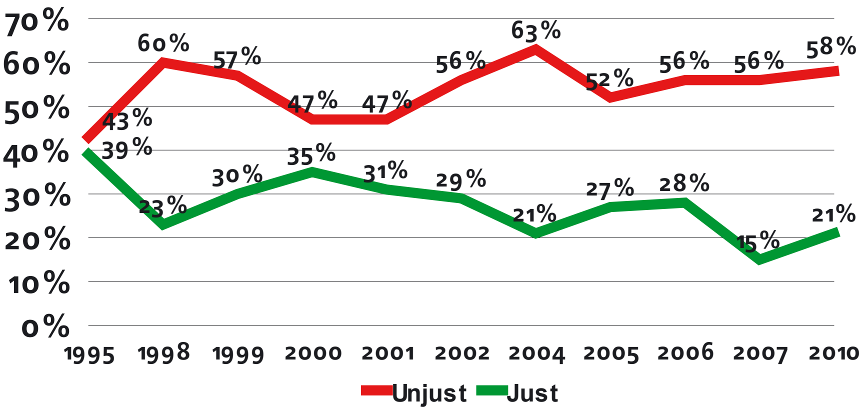
Chart 4: Evaluation of the "Social Market Economy" in the Values Coverage, German ARD and ZDF News Shows, 2001-2010



Basis: 533 reports about the situation in Germany with regard to political values

So that, in the end, in the light of this news selection, people come to an assessment of the strength of their own democratic financial system – which in no way corresponds to reality: workplaces were created, as it should happen only once in the history of Germany. For the first time, more than 40 million officially registered workplaces were reported in 2010

Chart 5: Opinion Poll "Equity", 1995-2010



Basis: Poll among Germans aged 16 and older;
Question: "What do you think: Are the economic conditions in Germany – I am speaking about what the people have and what they earn – by and large just or not?" („Wie sehen Sie das: Sind die wirtschaftlichen Verhältnisse bei uns in der Bundesrepublik – ich meine, was die Menschen besitzen und was sie verdienen – im Großen und Ganzen gerecht oder nicht gerecht?"
Source: IfD Allensbach

Because the extent to which the people in Germany turned away from the social market economy in surveys, is the same extent to which their personal prosperity increased on average year on year, unemployment figures decreased and, to a degree, – at an overall population of 80 million. Experts have long talked about full employment, but discussed far more frequently is the fundamental problem that not enough qualified employees are available for the market opportunities on offer.

In principle, at least in the largest national economy in Europe, an excellent environment has been created to sustainably discuss and solve the fundamental problems in the financial world. However, the communication by the financial institutions does not give people the impression that

a) they are interested in working on the problems which led to the financial crisis, and
b) due to this lack of interest, they are not able to offer any proposals for solutions.

To date, such sets of circumstances have historically always led to actions in particular on the part of those who felt as if they had been fundamentally harmed. Such a “keep it up” attitude towards financial institutions harbors massive risks which they, but even less the responsible politicians, can neither evaluate nor shape.

1.2. Two Years After Lehmann: Reputation Remains a First-Rate Risk for Banks

by Matthias Vollbracht

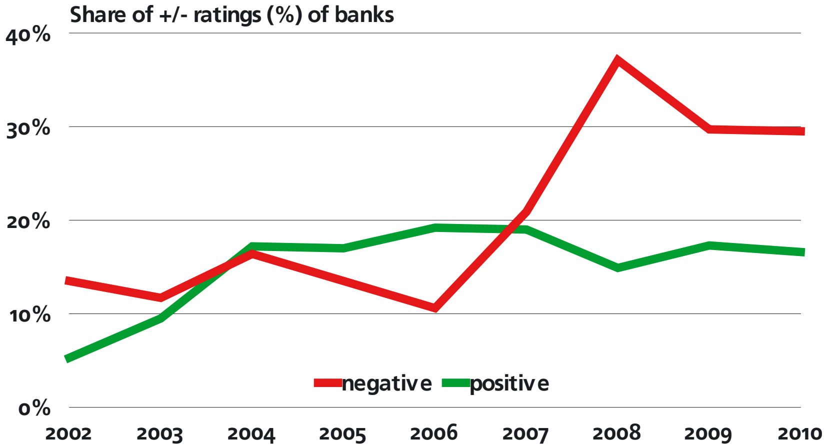
We believe that banking crises will happen again
Hans Wright, S&P, FT, 06.01.2011

Banks still struggle to regain trust – reputation risks are said to hinder business

The financial industry faced two major reputational challenges in less than a decade: first Enron and the bursting of the New Economy bubble in the early 2000s, and then the international financial crisis followed by a recession in major global economies in 2007-2009. 2010 was a year of continued growth in major emerging markets such as China, Brazil and India, a year of recovery in Germany, Switzerland and a few other European economies as well as parts of Africa, with a double-dip development in the US and UK and a slump in some debt-prone countries like Greece, Ireland and Spain. Many news reports have placed the blame for the crisis more on the global banking industry, and less on excessive monetary policy and supervision failures or greedy investors.

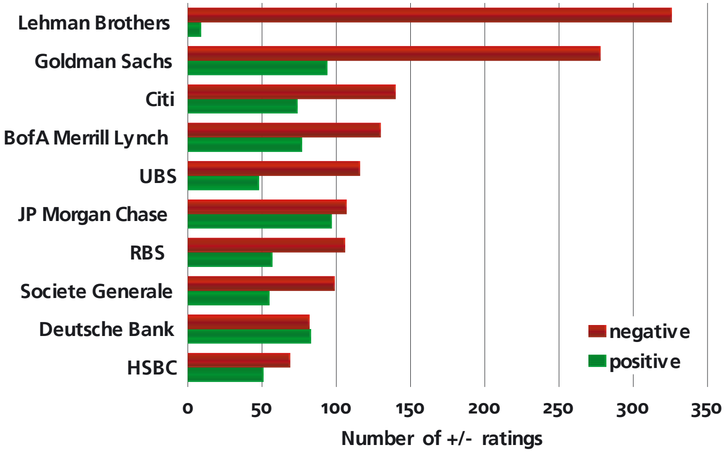
Banker bashing has become rather popular; during the height of the cri-

Chart 1: Rating of Banks – Financial Times 2002-2010 (Without Reports on Analysts' Research)



Basis: 140,548 reports on banks in the FT Europe

Chart 2: Top 10 Banks by Negative Reports – Financial Times 2010 (Without Reports on Analysts' Research)



Basis: 11,551 reports on banks in the Ft Europe

sis, the banking industry garnered up to 50 percent of all the business coverage by major international TV news broadcasts. So, has the global trust meltdown in the financial industry continued in 2010 or are there signs of recovery? Is the media reporting about change in key image criteria such as products and customer relations, or are allegations of breach of trust and misselling still dominant? Media Tenor continued its comprehensive analysis of national and cross-national TV shows, as well as international leading business papers such as the Financial Times and The Wall Street Journal, on general topics and specific issues such as analysts' quotes to find evidence for improving the images or lasting criticisms of the financial industry and especially of banks.

In a nutshell, the slight recovery in the overall rating of the banking industry since 2008 cannot make up for the fact that the vast majority of stories are still rather negative, putting the banking industry at the same level as tobacco, energy (remember BP's oil spill) and airlines (the volcano eruption didn't help to improve the image). Even worse, the recovery is nearly entirely connected to private banks again reporting increasing profits and being less dependent on public loans and bailout guarantees. In contrast, the tone of coverage when it comes to products and customer services has dropped to an even lower level. Investigations into what went wrong and who is to blame have started with the expected time delay and led to negative coverage in 2010 as indicated in last year's Trust Meltdown Report No. 1. News coverage of investigations and lawsuits have shed light on business practices which are broadly not believed to have changed as yet. So, the media and a large part of the public seem to still be waiting for the righteous fruits of repentance as a precondition for rebuilding trust. As the Scriptures put it: Let your change of heart be seen in your works (Matthew 3:8). The hype over Goldman Sachs prior to BP's oil spill might be taken as example. Negativity was so strong that Goldman Sachs filed harmful media reporting as a reputation risk which might affect business (The Wall Street Journal, March 2, 2010).

This chapter explains more in depth the development of banks' images in analysts' quotes in international opinion-leading media (e.g. The Wall Street Journal, Barron's, Les Echos, Financial Times, and Mint). This is followed by an analysis of coverage in international or pan-national news networks (Cnn, Bbc World News, Al Arabiah, and Al Jazeera) and finally a glance at 40 international news shows from Europe, the Middle East, the US, South Africa and China. Unfortunately, the image tsunami isn't over yet, and there is little evidence that business as usual is going to bring any changes in the near future, as sovereign nations struggle to foot the huge bill of stimulus packages and bailout programs.

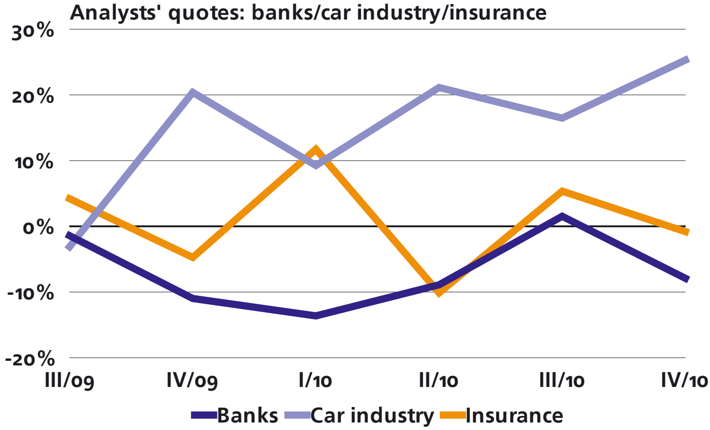
The analysts' view: what value is in the banking industry?

This section discusses analysts' views of banks. For these purposes, analysts are regarded as experts from banks, rating agencies and similar institutions. The analysis is based on an examination of experts' quotes in international financial media such as Barron's, The Wall Street Journal and the Financial Times, as well as Les Echos, Mint and Expansion.

Previous analyses of analysts' quotes by Media Tenor have already shown that the quoted experts, on average, gave companies more positive ratings than other sources cited in the media or even journalists themselves. Particularly striking was that at the time of the New Economy, but also after, little in fact changed.

A look at the automobile industry shows that analysts had apparently regained their trust. The upbeat sentiment and improved figures was in recent months positively reflected in rising share prices, the GM IPO not being the only indicator there of. The analysts' quotes on companies in

Chart 3: Rating of Banks / Insurance / Car Industry Analysts' Quotes, 7/2009 – 12/2010



Basis: 3,433, 12,807, 1,335 statements in 8 (9) international financial news media

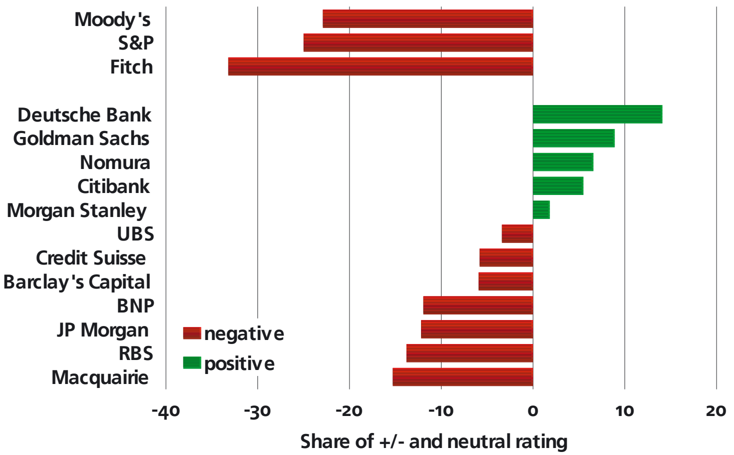
opinion-leading media have several functions: Firstly, they give journalists a third opinion (leaving open the principles according to which analysts' quotes were selected). There is, in any case, little empirical evidence to suggest that analysts with the most precise predictions were cited disproportionally compared to the others. Secondly, analysts' quotes render complex and condensed company information in concise, concrete figures and trends, such as buy/sell recommendations or profit estimates. The current level of analysts' assessments serves to assist both journalists and financial markets in the evaluation of new figures which has a significant influence on the tone of the reporting. Thirdly, analysts themselves indicate that the reporting, including quotes by other analysts, also contributes to characterise the further mood and sentiment.

How do the cited experts, who largely hail from the banking sector itself, now rate the situation in the finance industry? The trend analysis shows that there is no standard rating. This applies to both banks and insurance companies. With the exception of AIG, scores of insurance companies conceded that they had acted more conservatively than banks and that the sentiment towards them was thus friendlier than that towards banks. This is mirrored in the positive ratings of the first quarter of 2010, when the annual results of 2009 were reported on.

The successful handling of the so-called stress tests, in which the banks' balance sheets were tested for their robustness against shocks in respect to minimum equity requirements, was a positive factor in analysts' commentaries in Q3 2010. The climate of opinion for banks and insurance companies thereafter, however, deteriorated again. Contributors to this turn of events were concerns regarding the possible failures of highly indebted countries such as Ireland, but also a certain worries of what influences a tightening of regulations in the form of Basel III would have on the business development of banks. For insurance companies, the scepticism related to the consequences of the low-interest environment in parts of Europe and the US as well as the possible effects of Solvency II.

The picture is very heterogeneous with regards to cited sources. After the rating agencies stood massively under fire during the financial crisis due to their clearly over-positive statements on toxic assets, they switched to "at risk" in their ratings of banks. The most negative ratings, on average, were cited from Fitch, but also Moody's and S&P negative ratings trumped positive ratings by

Chart 4: Rating of Banks by Different Analyst Sources, 7/2009 – 12/2010



Basis: 3,433 statements in 8 (9) international financial news media more than 20 percentage points. In the current environment, the regained scepticism is, of course, only credible to a limited extent, but it is another nail in the coffin where it comes to banks' regaining trust.

If one leaves the rating agency sector and compares the ratings by bank analysts, then the comments by Deutsche Bank and Goldman Sachs were the most advantageous on the whole, whereas Macquarie, RBS and JP Morgan were on average, quoted regarding negative ratings. The quotes by JP Morgan had a special role to play. JP Morgan not only passed the stress test with flying colours, but fed the debate around the capital requirements of major international banks with its own calculations.

On the whole, analysts' and experts' quotes still did not give the banks the all-clear as core capital is assumed in the additional regulatory requirements. Analysts, however, exclude the question as to whether the business models will receive their license to operate, not only in the legal sense, but also in the social sense.

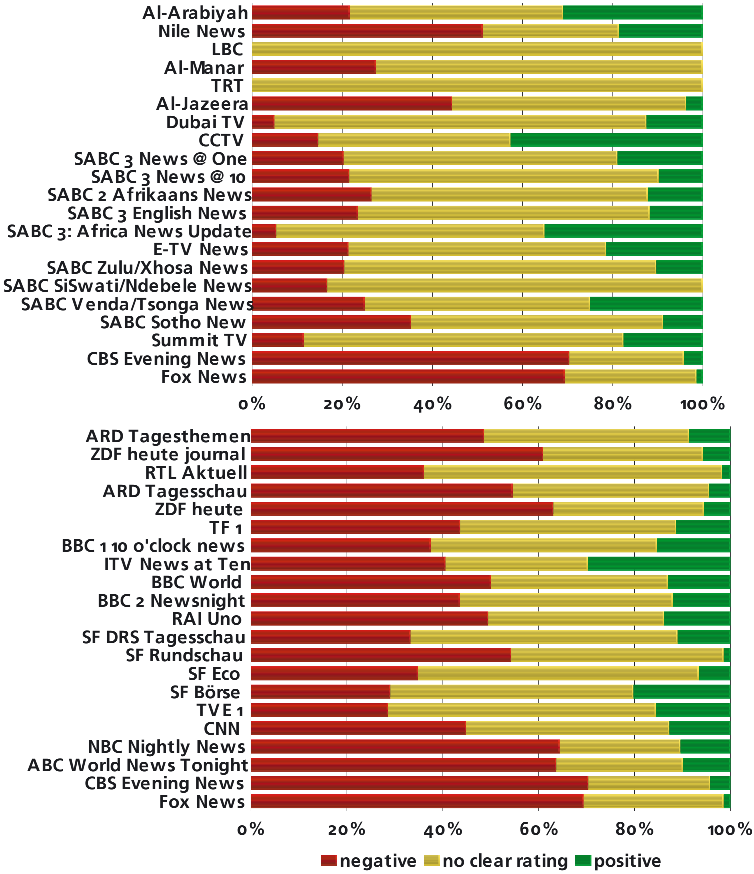
Does watching CNN make a difference?

From the viewpoint of reputation management, the issue of whether the image is negative in all or most broadcasts, or particularly negative in certain types of broadcasts, e.g., for certain target groups (regional / according to subject matter) is an important one. As a rule, news broadcasts are destined for a regional news audience for reasons relating to language. It is possible that there is a relevant number of the world population who are in the position of following and understanding English broadcasts if they could be received locally via satellite or cable. The well-known research studies on market share nevertheless state that these broadcasts are rather less attractive to the masses compared to popular local news offerings. This would, however, not necessarily limit their significance for image creation taking into account the extent to which opinion leaders such as analysts participate in the creation of images, and the extent to which such offerings are consumed.

In addition to the local/international news broadcasts, pan-national or international formats such as BBC WORLD, CNN, AL JAZEERA and AL ARABIYA were analysed. BBC WORLD and CNN, in particular, claim to be the global elite media and AL JAZEERA and AL ARABIYA are, in any case, beyond national boundaries both important news platforms in the Arabic-speaking world.

An analysis of individual broadcasts proves that the reporting on banks

Chart 5: Tone of Coverage on Banks in Individual News Shows, TV News 1 – 11/2010



Basis: 7,227 stories on banks on 40 international news shows

is predominantly critical in the rating of most broadcasts. The image of banks portrayed by BBC WORLD was thus as critical as that on the national BBC and on ITV. The situation is somewhat different for CNN. CNN recorded a rather less critical view of banks compared to NBC, ABC, CBS and FOX.

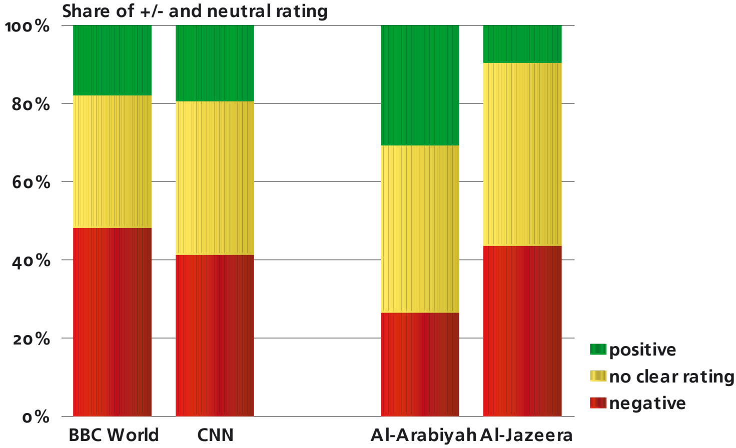
Despite this, the percentage of negative ratings was over the 40 percent mark and, in this regard, no other image was, in principle, transmitted via CNN that was not transmitted by the other American formats.

If one compares the pan-regional and internationally oriented broadcasts with national broadcasters, then the differences in the structure of the subject matter, at first glance, do not necessarily explain the differences that exist in the ratings. It is rather to be expected that broadcasts with a high proportion of research quotes by banks portray a rather neutral picture. The research component, however, is not immediately noticeable in the international and pan-regional formats.

More striking is that the focus on managers, another major negative factor in reporting, was less than on the national shows. For example: On CNN, 6.8% of the contributions between January and November focused primarily on management, whereas on ABC and CBS the proportion was 16% and 17% respectively. For BBC WORLD, the proportion was 6%, and at BBC 1 10 o'clock it was twice as high.

In respect to rating, BBC WORLD and CNN thus do not necessarily make things easier for the banking indus-

Chart 6: Tone of Coverage of Banks in Individual News Shows, TV News 1 – 11/2010 (Only Individual Banks)

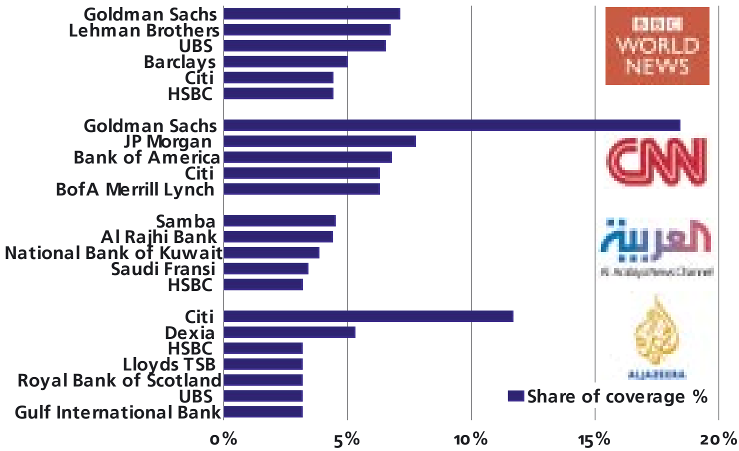


Basis: 217/131/420/21 reports on banks on the news shows listed above try. The analysis provides further insights on which companies were addressed in the individual broadcasts.

Internationally, Goldman Sachs has become synonymous with (investment) banks. With respect to the survivors of the financial market crisis, in many of the numerous media reports Goldman Sachs stood for those business practices that were denounced. This is actually somewhat surprising in view of the changes in the banking landscape in the last two years, as it was Goldman Sachs's competitors which were primarily involved in the takeovers of the no longer competitive competition, while the organisational structure of Goldman Sachs, with the exception of its declaration as a commercial or investment bank to the US authorities, was subjected to less obvious fluctuations.

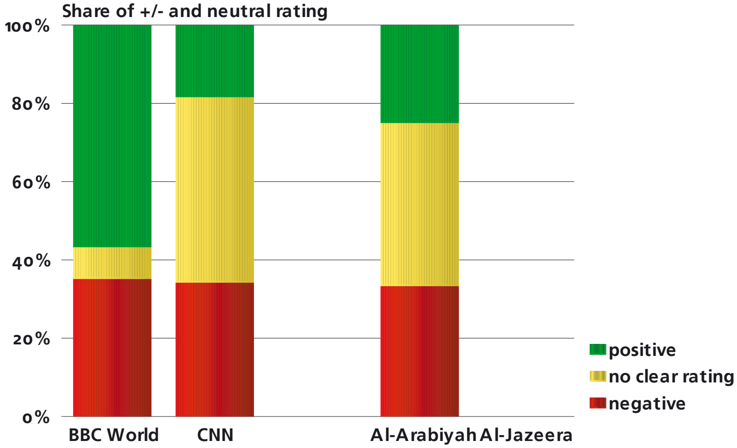
In 2010 Lehman Brothers was still present in the media as a historical reference – and even named relatively often. However, more than 5% (BBC WORLD NEWS) and more than 15% (CNN) of contributions about banks concerned Goldman Sachs between January and November. While most of the contributions appeared between January and July, the focus was on April. Whereas in 2009 Goldman Sachs, was still blamed for the relative persistence of the crisis, at least in some media, the image was,

Chart 7: Relative Visibility of the Top 5 Banks on Individual News Shows, TV News 1 – 11/2010



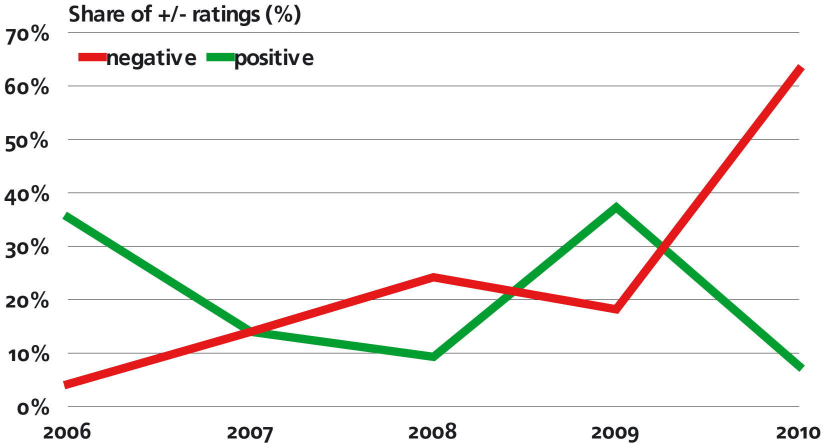
Basis: 217/131/420/21 reports on banks on the news shows listed above

Chart 8: Rating of Goldman Sachs on Individual News Shows, TV News 1 – 11/2010



Basis: 37/38/12/0 reports on GS on the news shows listed above

Chart 9: Rating Timeline of Goldman Sachs on International TV News Shows, 2006 – 11/2010



Basis: 628 reports on Goldman Sachs and senior management in international TV news shows on the whole, negative in 2010. Until the oil platform crisis, the fraud investigations against Goldman Sachs were the top subject matter for weeks – and not only on the US news.

Reporting in the second half-year was more balanced, not least after the SEC hearing, but Goldman Sachs's image clearly did not remain untarnished, even in the elite media, BBC WORLD NEWS and CNN.

Against this background, the question that must be asked is this: is the absence of bad news the start of reputational recovery? The latest headlines regarding the appointment worth billions at Facebook has already led to warnings that this could mark the next bubble. The analysis makes evident that profits alone can no longer ensure a good image for management, products and social responsibility.

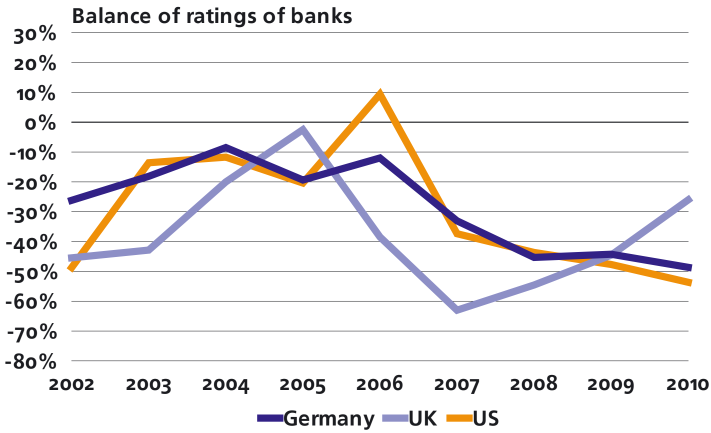
After digressing regarding selected international media, we will go on to take a further look at the image of banks, this time from the point of view of the competing news broadcasts.

Some kind of stabilization but no clear recovery

Banks have barely seen balanced or even positive news coverage in the recent past in international TV news. That is to some extent due to the nature of TV – strong polarization given the lack of space and time to explore issues in depth and a tendency to polarize ratings. However, TV news characteristics are not enough to explain the level of negativity as other industries have, at the same time, done much better. Overall ratings (expressed as the sum of positive minus negative ratings) have ranged between +10 and -60 in the period 2002 to 2010 with the UK news, on average, presenting the harshest image. According to MEDIA TENOR's long-term research, a reputational crisis manifests if a rating hits the -10 mark for more than two months in a row. Looking at these criteria, the banking industry achieved a somewhat sustainable rating in 2005 and 2006 only.

After the collapse of Lehman and a banking crisis which saw central banks and politicians fearing meltdown, ratings were rather low in 2008 and 2009, registering at below the -40 mark in Germany, and the UK and US media. Apart from Leh-man, the names differed from country to country (e.g., Hypo Real Estate in Germany, Northern Rock in the UK, Washington Mutual and Merrill Lynch in the US), but the message was more or less the same: Toxic subprime papers mainly related to an inflated US real estate market were packaged and sold all over the world, leading not to risk diversity,

Chart 10: Rating of the Banking Industry, Germany, UK, US (TV) 2002-2010

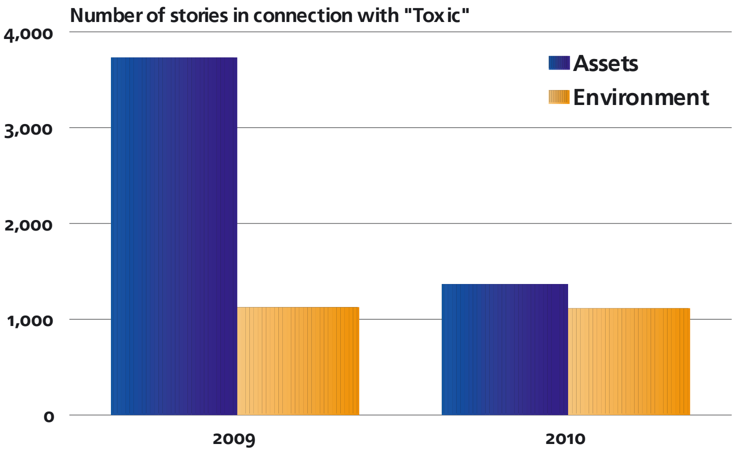


Basis: 10,886 / 3,192 / 3,934 stories of banks and their senior management in German, UK and US TV news shows

but rather to an international pandemic infection of banks. If this had happened in the food industry, supervisory bodies would have immediately shut down (toxic) production. In the banking industry, the so-called sub-prime crisis no longer held water, but central banks and financial authorities rushed to give support to troubled banks trying to prevent another major systemic shock the size of Lehman. Even in 2010, the word "toxic" has more often been connected with financial issues than environmental issues, as research in Ft, Wsj and Barron's for 2009 and 2010 shows. As no one in their right mind would want to be poisoned with toxic food, investors wouldn't want to be poisoned with toxic assets. And self-regulation or a soft approach such as public warnings might not be sufficient when it comes to regulators, central banks and rating agencies – or when it comes to rebuilding their reputations.

What is the current trend now? Overall ratings have deteriorated further in Germany and the US, given further insights (e.g., by courts and federal investigations shedding light on business practices which have been labeled criminal acts). In Germany, this has especially hit publicly held Landesbanken which have seemed to be strong buyers of structured loans giving a higher average return and

Chart 11: Connotation of the Word "Toxic" 2009/2010



Source: Ft, Wsj (print & online), Barron's, text search

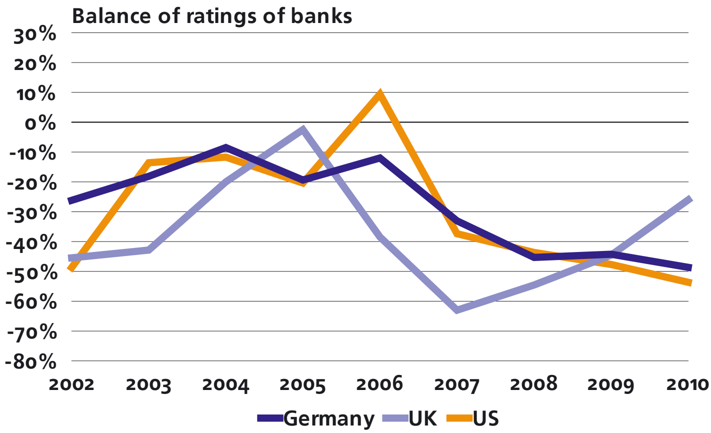
lacking an otherwise sound and sustainable business model. Based on the general ratings and stereotypes analysis, the image turnaround has yet to come as current rating levels are not sufficient for rebuilding public trust. Rising profits on the back of an economic recovery will not be enough to restore credibility. The ground for revelations such as those announced by Wikileaks is rather fertile. The "Move your Money" campaign launched by Huffington Post's Arianna Huffington before Christmas 2009 has, according to the website, encouraged around 9 per cent of US adults to turn away at least some of their money from the big banks (http://moveyourmoneyproject.org/archives/1514) during the first quarter of 2010. Future actions might have an even larger impact.

Bank managers: bashing continues

Given the strong trend towards personalization in news reporting, and taking into account the fact that business is always about people – even if they are developers and programmers of automatic trading programmes – the rating of senior management in the banking industry is another key indicator for measuring whether public acceptance is on the rise again or not.

Recent polls (e.g., in Germany) have shown slight improvements for

Chart 12: Rating of Bankers, Germany, UK, US (TV) 2006-2010



Basis: 1,468 / 431 / 559 stories on banks' senior management in German, UK and US TV news shows

Deutsche Bank's Josef Ackermann, but the diagram above makes the point that this is not a general trend. Instead, in 2010 negativity in Germany again moved to even lower rankings than in 2008 and 2009. At the same time, the ratings in the UK and US TV news improved slightly, but still showed a -45 – 40-point gap to any substantially balanced coverage which might award bankers with more trust again. The GfK 2010 trust index shows that bankers lost 15 points compared to 2008 in Germany, scoring at 57 per cent in 2010.

The volume of negative reports decreased in 2010 compared to 2009 as the cameras shifted to BP's Tony Hayward, but, in light of the massive volume in 2008/2009, a moderate volume with consistently negative tone is enough to keep the fire burning.

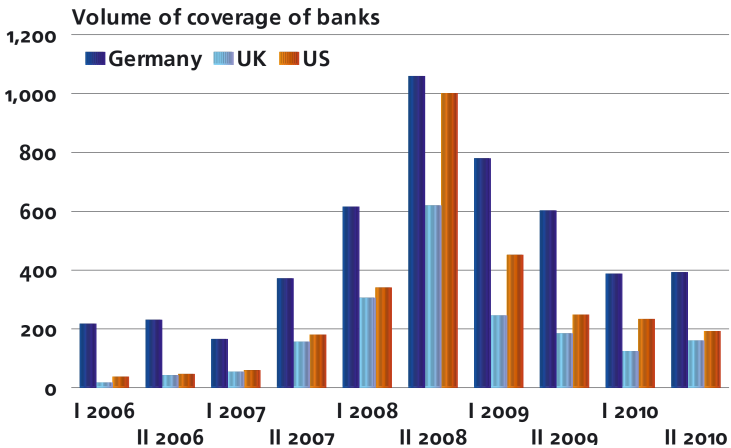
A breakdown by companies shows the most negativity for Goldman Sachs in 2010, in Germany for BayernLB, Hypo Real Estate and in the U.K. for HBOS and RBS.

Besides the fact that investigations and court cases continue to fuel the fire, the lack of prominent senior managers from the global financial industry heading a campaign to unveil what went wrong and lobby for substantial change might be a reason behind the slow image recovery in senior management. So far, it has been up to movie makers, politicians, scientists and journalists to head up the education on the reasons for and the lessons learned from the crisis. How do you rebuild trust? Much of the global media is currently promoting the idea of increased diversity, especially that of having more women in prominent management and controlling positions, allowing them to manage change and communication. The investment banking culture, in particular, has been frequently labelled as male dominated and driven by testosterone rather than reason (e.g. Handelsblatt 16.09.2010). There are too few cases of prominent female bank CEOs to do a forecast on whether this would cause a change in reporting on banks' management. Experience in other industries (e.g., IT) indicates that it is more about integrity and readiness to take on responsibility than on gender alone.

Banking visibility: volcano eruption and BP's oil spill eclipsed banking industry news in 2010

MEDIA TENOR's fundamental research has unveiled that trust basically starts to recover around nine months after negative coverage ends and an issue is no longer grabbing top headlines in the media. The previous section of this chapter has shown that the tone towards the banking sector hasn't changed fundamentally so far – so

Chart 13: Volume of Coverage of Banks, Germany, UK, US (TV) 2006-2010



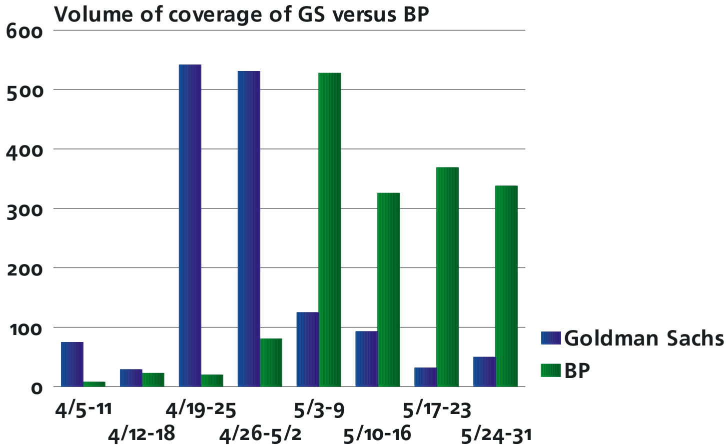
Basis: 4,827 / 1,916 / 2,797 stories on banks (brands) in German, UK and US TV news shows what about the volume aspect? As with the bankers, the volume of coverage on individual banks declined substantially in 2009. However, other Media Tenor rankings show that volume in 2010 was still large enough to claim a top spot in the industry rankings. Another important fact is that the volume of coverage still exceeds pre-crisis levels. In Germany, volume in 2010 was around double that of 2006, and on the UK and US TV news it was even more.

Some senior industry figures have been for the storm to pass over before emerging from their caves to continue doing business as normal. The tone and visibility analysis shows that this hope has not been fulfilled. Instead, there is evidence that the level of negativity was sufficient to make people move their money. There has been no successful campaign in Germany similar to that in the US, but the business figures of the small German GLS Bank, which claims to be doing sustainable business only, show that people outside the US moved their money as well. GLS reported a rise in client numbers from 55,000 in 2007 to 80,000 in summer 2010.

Banking and financials – a silver lining

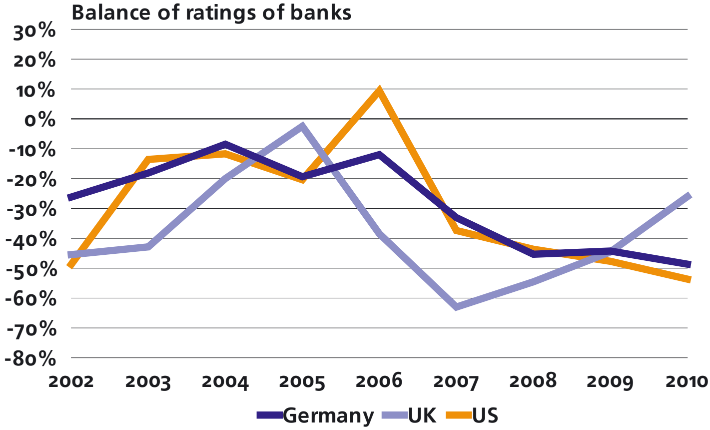
If there is one image criteria which has really shown some progress in

Chart 14: Volume of Coverage of Goldman Sachs versus BP, UK, US and German media April, 5 – May 31, 2010



Basis: 4,827 / 1,916 / 2,797 stories on banks (brands) in German, UK and US TV news shows

Chart 15: Tone of Coverage of Banks: Financial Solidity / Stocks, UK, US and German TV News 1/2006 – 11/2010



Basis: 2,083 / 1,120 / 830 stories on banks on German, UK and US TV news shows

tone then it is the news coverage on banks' financials and stock sentiment. The bailout programs, a dive for cover in fixed income business and low interest rates boosted earnings in 2009/2010 compared to the previous years. In principle, financial solidity is a core image criterion as it is in general considered to be an equivalent to overall success and thus makes a company attractive to investors and employees (with clients it's not that simple). Reports about financial constraints have accelerated the decline of banks such as Northern Rock and, especially in the banking industry, any rumors about solvency problems might be as bad as a factual shortage of liquidity because such rumors tend to be self-fulfilling prophecies. Theoretically, increased profitability might be good news for banks' images. Unfortunately, the trust meltdown and fundamental criticism of the business model doesn't allow for a 1:1 transfer of higher profits to improved image. Even the ratings of organizations such as Deutsche Bank and Goldman Sachs display a high level of ambivalence when it comes to the rating of financials/stock. Deutsche's 41.5 per cent share of positive rating on financials in 2009/2010, for instance, contrasts with a 20.3 per cent share of negative reports.

Why is this? One reason might be that the discussions on passing so-called stress tests and tighter governing rules concerning equity capital have made journalists point to concerns that even increased profitability will not be enough to meet future challenges. Some of these concerns are shared and disseminated by the rating agencies as well. However, another, probably more challenging, argument when it comes to trust is that the media and sources quoted by the media questioned the legitimacy of recent profits, especially those generated by investment banks. A recent FT story (13.12.2010) in which the words "investment bank" and "casino" are used as synonyms is typical.

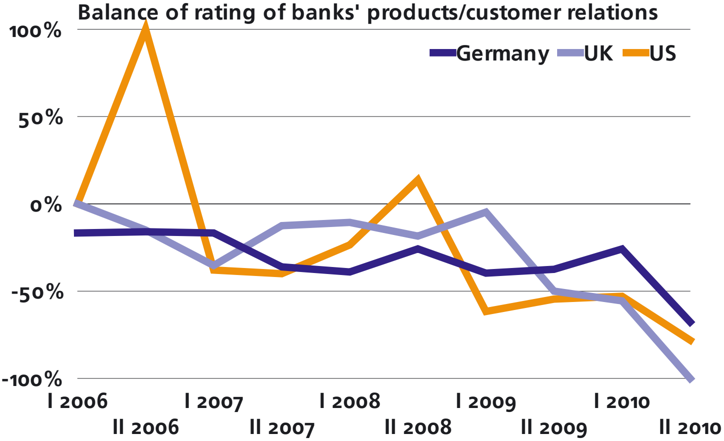
Unfortunately, the positive profit news can, to some extent, even be counter-productive when it comes to rebuilding trust. Besides the arguments listed above, rising profits go hand in hand with increasing bonuses and the 2010 coverage on bankers' bonuses garnered little public sympathy with bankers cheering higher earnings.

Banks and customers: troubled relations not just on toxic products

At the end of the day, the mere reason for the existence of businesses is to offer products and services and make money that way. According to Adam Smith, competition – the invisible hand – will turn egoists into cooperative individuals because of their personal advantage if they start to serve (potential) customers better than competitors. As a result, the welfare of the provider of goods, as well as of the customer, will increase. So much for the theory. When it comes to banks and customers, the media have shown little evidence over the course of the last three years that the bank-customer relation, on average, leads to happier clients. Criticism hasn't softened since then despite a great deal of negativity immediately after the collapse of Lehman, when many private banking clients realized that they had lent money to Lehman without actually knowing that they had done so. In 2010, the balance of negative and positive ratings hit the -60 to -100 mark.

Basically, if banks have been in the news due to their products and client relations, the story has been negative. The trust polls display that this type of coverage hasn't enhanced reputations. Basic trust in the industry is challenged as court trials shed light on the mechanics of creating and distributing products, which only a few people understand, and how banks didn't counsel customers according to industry and legal guidelines. This finding is not a contradiction to polls such the GfK industry poll which says that around 50 per cent of people have some kind of, or full, trust in their personal service person.

Chart 16: Tone of Coverage of Banks: Products / Customer Relations, UK, US and German TV News 1/2006 – 11/2010



Basis: 437 / 255 / 73 stories on banks on German, UK and US TV news shows

Criticism has circled around various issues as different types of clients and relations were linked to the financial and economic crisis:

a) Inter-bank relations: e.g., selling toxic assets to other institutions making them bailout cases costing taxpayers money; there have been allegations of fraud and insider trading as well, drying up funding for other banks

b) Banks – corporates: funds drying up during the economic crisis worsening companies' problems in dealing with declining orders and investing in new technology

c) Banks – private clients: selling real estate loans to people who cannot afford them and who are not educated in managing large financial risks; selling complex investment products to private clients who do not meet their risk profiles; communicating in professional language and terms of business which are normally not understood by private clients; excessive fees for "minor" violations of client contracts, e.g., delayed credit card debt payments; inappropriate handling of customer data (e.g., data were stolen or published)

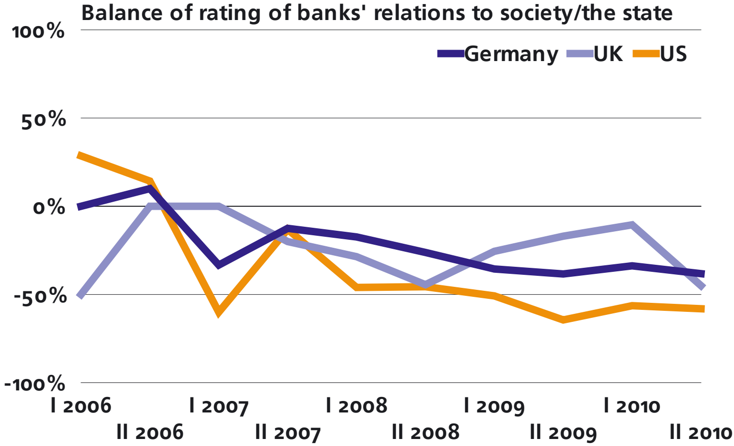
The connector between these very different types of problems is a perceived lack of integrity and common sense regarding what sustainable business relations are all about. What might be the trigger to find a way out of the trust crisis surrounding products/services and customer relations? Obviously, launching Facebook pages and spamming clients with information in social media will add to the frustration and aggregation rather than rebuild trusting relations. Some companies have been able to achieve fair and balanced coverage by putting customer advisory boards in place which meet on a regular basis and have the right to recommend basic changes in the design of products or customer communications. Another way of building customer relations can be the communication of solutions, e.g., the successful financing of technological innovations and company growth. However, in the age of online media, these stories can no longer be communicated by press releases alone, but need to be told in compelling stories showing company staff and customers at work.

Banks and the state: taming the beast

Corporate citizenship has become a popular concept in business over the last decade, and banks have invested heavily in cultural projects, foundations and environmental issues. It seems obvious that such positive reporting on good corporate citizenship is likely to build trust between the company and the regional or national community. However, the discussion about banks since the collapse of Lehman has gone far beyond the question of how much of profits have been invested in art collections. In the light of the systemic crisis, even countries with a strong economy and low public debts have realized that banks can become too big for a national fix if things go very wrong. Until 2007, the term systemic risk was insider vocabulary among regulators and central banks and, in the business news, bigger was said to be better while mergers were mostly cheered. Three years of this has taught journalists that the rescue of a single bank can be more expensive than all the money spent on social benefits for an entire country in one year. Economic stimulus packages and bailout packages for the financial industry have led to spiralling public debt in scores of countries between 2008 and 2010. So it is little wonder that the tone of coverage has been mostly negative since 2007 when it comes to the media reporting on banks and their relations with state and society. In this context, mistakes by regulators and public supervisory bodies have played a certain role. However, most of the time, media reporting was not so much centred on institutional failure but on factual or claimed unlawful behaviour.

The slightly upbeat reporting on the UK TV news contrasts with a declining rating in Germany and a still

Chart 17: Tone of Coverage of Banks: State / Society / Regulation, UK, US and German TV News 1/2006 – 11/2010



Basis: 1,089 / 332 / 720 stories on banks on German, UK and US TV news shows

strongly negative tone of coverage in the US Banker bashing and calls for tougher regulation, additional taxes on banks' profits and higher equity requirements have provided fertile ground for politicians to put the blame on the banks. But, as explained in last year's Trust Meltdown study, it has been seen by at least some politicians as a chance to come back to the playing field after globalization was said to have diminished the power of national governments.

Are last year's and current efforts, such as Basel III, additional taxes and considerations, overdone and is there enough systemic relevance to rebuild trust in the banking industry? If they are communicated as measures to improve stability and global welfare and are met with constructive cooperation by the banks, it could happen. However, the coverage has shown how difficult it is for international politicians such as the G20 to find and apply common rules. And the banking industry has stressed the negative consequences of greater regulation more than it has displayed any kind of repentance and concern over the next crisis. Instead, there are some signs of a return of project-focused CSR management. It is doubtful whether this will be helpful for rebuilding trust.

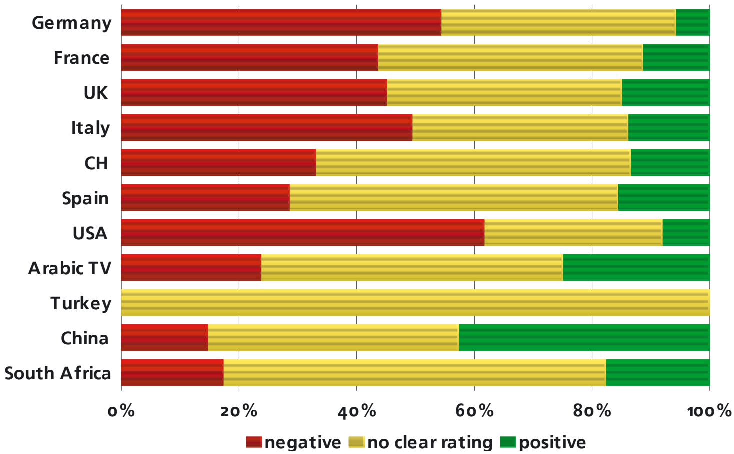
Balanced image profile in emerging markets

In recent years there has been much talk of a global financial and economic crisis and, in general, scores of commentaries also stated that bankers had an image problem the world over. This could, of course, be the case, but in light of the analysis of news broadcasts in 11 different countries/regions, the information emanating from the media need not necessarily be responsible for this. An analysis of a total of 40 news broadcasts in these 11 countries over 11 months in 2010 shows that the ratings of banks in Switzerland and Spain were clearly less negative than in other European countries and the US, and that the ratings in the Arabic-speaking news and in China and South Africa were on the whole balanced or positive for the sector.

Against this background, can the theory that the banks' image crisis is an international or global phenomenon which requires relevant basic measures hold water, or are the ratings in China, the Arab countries and South Africa proof instead that reactions in countries such as the UK or the US and Germany were more excessive and that this will normalise in the near future?

The answer to these questions must focus on various aspects. The ques-

Chart 18: Tone of Coverage of Banks in Different Countries, TV News 1 – 11/2010



Basis: 7,227 stories on banks on 40 international news shows tion on the one hand concerns the extent to which the banks from the home countries or home regions were affected by the distortions of the financial crisis, and the extent to which the media reported on the distortions and their consequences. It must be noted here, that the extent of the effects fluctuated from market to market, and amongst others, depended on the degree to which the banks were enmeshed in the international capital market and bought the toxic assets and held them in their portfolios.

It is hardly surprising that, at the starting point of the crisis in the US the picture was the most negative. It was here that the most bank insolvencies occurred as a result of the distortions, and it was here that the subprime property market and the high liquidity of markets were considered by many experts to be the main causes for the international crisis. In 2010, the German media engaged itself critically with the mistakes in the field of the public banks, above all by WestLB and LBBW, but also of BayernLB and others. The problems of private banks were reported on to a greater degree in 2008/2009. In this regard, it must be noted that the image problem of the banks, which led to a reputation problem, was a fundamental problem at least in Europe including the UK and in the US.

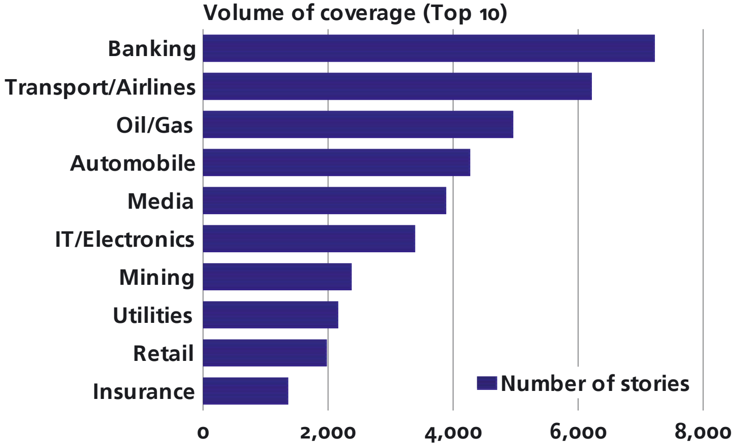
The reports on Chinese TV, in contrast, reflected a somewhat different type of news selection and preparation than in other countries. The picture for the banks is the same for the other sectors, although there were, for instance, major distortions in the Chinese economy due to unemployment and wage pressures.

The picture in the Arabic region can be summarised as follows: For the domestic institutions, the picture was, on average, better than for the foreign institutions (e.g., US institutions). In view of the financial services offered in the Arabic region, there are surely in-principle differences (Takaful products conforming to the Islamic religion which exclude certain products/product types) on the one hand, and, also a certain (self-)censoring in the reporting on local/regional authorities in order to avoid problems with official censorship.

The banking image seen in context

There are various indictors for the drop in crisis reporting. One indicator is an improvement in the rating. We have seen in the above that banks at this point continue to lack a breakthrough which would lead to the regaining of trust on a broad scale. Another indicator is absolute presence and presence compared to competing news broadcasts. With respect to absolute presence, it was shown above that although the reporting

Chart 19: Volume of Coverage of Different Industries, TV News Shows 1 – 11/2010



Basis: 58,212 stories on companies and managers on 40 international TV news shows

on banks in 2010 was lower than that of 2008/2009, visibility was therefore less as a result. However, looking at relative presence and rating as an aid, i.e., comparing the attention paid to the banking industry with the visibility of other industries, then there are no indications of normality yet, even from this side.

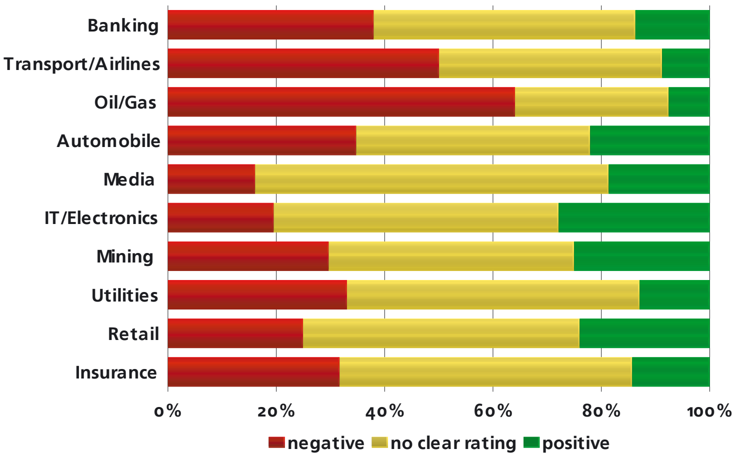
Despite crisis events, which partly kept the world media on edge for weeks, the banking industry remained the top industry in respect to attention in the period January to November 2010. It also competed with industries such as the energy sector, airlines and the mining companies – all of them providers of shocking headlines and pictures in the past year.

In addition to strikes and spectacular accidents, the volcanic eruption in Iceland ensured a high degree of attention on transport companies and airlines. The accident involving the BP platform in the Gulf of Mexico put the oil companies in the centre of attention of the worldwide media, and the automobile industry has always enjoyed a high degree of popularity from journalists, even on TV news. Unusual and more tragic was the presence of the mining companies. The accident in Chile, with its weeks-long rescue work until the happy ending, dominated the news in late summer. However, the relatively high degree of attention for insurance companies was unusual. A significant proportion of the attention fell on the US giant, AIG, which had hit the skids during the financial crisis and was stabilised with record sums. The investigations on the crisis and the possible sale of Asian branches to repay debt were important topics, especially on the US news.

An analysis of the ratings of industry reporting shows banks ranked third – only superseded by airlines and the energy industry. In contrast, the media see automobile manufacturers, even the "Detroit Big Three," as clearly re-consolidated in the meantime. The image winners in industry reporting by international TV news shows were, however, the retail and IT industries. In any case, these were among the most frequently named industries. In regard to the IT industry, Steve Jobs scored above all with Apple and the media again saw in the iPad, a pioneering role for an entire industry.

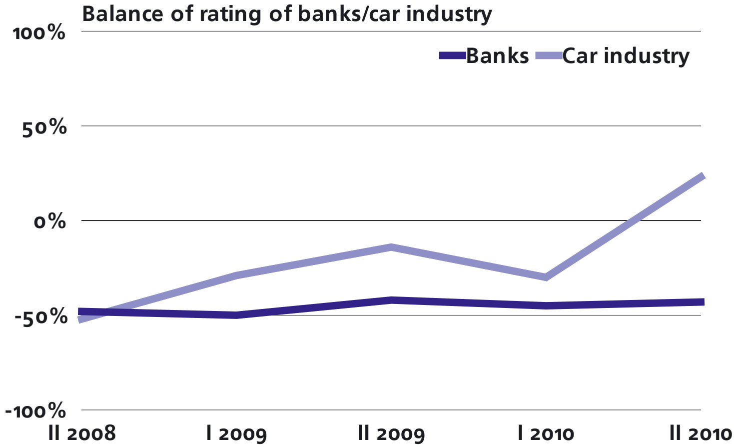
Less in the spotlight were other parts of the financial sector, such as private equity and venture capital companies as well as funds. Here the image was relatively balanced on the whole, while clearly friendlier than for banks

Chart 20: Rating of Different Industries, TV news shows 1 – 11/2010



Basis: 58,212 stories on companies and managers on 40 international TV news shows

Chart 21 Rating of Banks / Car Industry, TV News Shows 7/2008 – 11/2010



Basis: 22,667 stories on companies and managers on 40 international TV news shows

and insurance companies. Above all, venture capital financiers were able to score. In this area there should also be a point of reference for image recovery for the banks in communications and strategy to address their role as enablers of growth, workplaces and the well-being of the company.

Insurance companies, on the whole, fared better than banks, but even here critical evaluations were the order of the day. These, however, affected more the field of products/prices/customer relationships, particularly in the health insurance sector.

If one compares the reporting on banks and automobile companies in the medium term, then the clearly more beneficial evaluation trend for automobile manufacturers immediately becomes apparent. If, in 2008/2009, it was about the survival of companies such as GM and the European subsidiaries of Opel and Chrysler, and if German companies battled a drop in demand and short-time work, then the positive evaluation trend in 2009/2010 not only contributed to the economic recovery, but to recognition by the media that important headway was being made on the way to more sustainable mobility with electric and hybrid cars which use up less resources and emit fewer hazardous pollutants. In addition, the media triggered an innovation competition, including the issue of how suppliers from high-wage countries could also produce low-cost cars for future drivers in India and other emerging countries. There is no talk of such fundamental changes in the business model in the reporting on the banking industry, rightly or not. Here, the media do not (yet) see an in-principle change in course on a broader basis.

Closing remarks

Irrespective from which perspective the international banking sector is examined, whether regarding the subject matter of financial solidity, customer relations or the handling of mistakes in the past, the basis for a return to trust on a wider front is not yet apparent from the various media channels investigated. There are certainly markets, such as in South Africa and China, which have appeared to be unaffected by the crisis news reports, but, in the most important financial centres, scepticism dominates in the wake of the collapse of Lehman Brothers and the bursting of the subprime bubble. The simple improvements to image which arose from the field of finance have not been sufficient to raise the average. In addition, there remains unease regarding higher bank profits, in particular in politics and NGOs. A few individual companies have succeeded in keeping their image on an even keel or in bringing it back on a constructive course in its early stages. This was usually based on three elements: (1) Admitting to past problems and keeping up a continuous flow of news on their successful handling (e.g., reducing toxic papers, improving risk management). (2) More intensive media communication, in particular at top management level (3) Clear communication for the customer's benefit, improvement measures and growth areas (e.g., innovation financing). But journalists still see such companies as the exception rather than the rule.

1.3. Only he Who is Understood Can Convince. The Comprehensibility of Bank Communications

by Prof. Dr. Frank Brettschneider and Dr. Anikar M. Haseloff

1. Comprehensibility and acceptance

The effects of the worldwide financial and economic crisis were also felt by numerous small investors in many countries. In many cases the financial losses have been the result of speculative forms of investment, the risks of which had been inadequately explained to bank customers. As a result, communication by the banks – with the public in general and with their customers specifically – has shifted further into the limelight. Legal regulations, such as providing an easy to understand product fact sheet, are being discussed in some countries. In Germany, for instance, the obligation to record consultations with potential customers is included in these new laws. Communication by the banks with their customers is also being subjected to several quality tests conducted by different customer care organisations.

Numerous problems due to inappropriate advice and the continued negative results achieved by banks in tests which examine customer consulting lead to some questions: How easy is it to understand financial communications? Are bank documents comprehensible to end customers without special prior knowledge? Has the financial and trust crisis led to a situation where banks place more value on comprehensibility?

In particular, when it comes to banks, customers want to be comprehensibly informed of the features of the products and the risks. The internet also plays a decisive role in this process. It is easier than before for customers today to compare the documentation on products or Terms and Conditions. When deciding to purchase a product or not, one of the main issues is comprehensibility. One can only compare or consider products and Terms and Conditions that are understandable. And for journalists, comprehensible press releases have a greater chance of being selected from the flood of reports that arrive in editorial offices on a daily basis. Therefore, comprehensibility is not only meaningful in direct communications with customers, but also in indirect communications transmitted via the mass media.

Banks thus have a great opportunity to regain and develop the trust of their customers and the public in general by using easy to understand and transparent communication. Comprehensibility can also be a competitive advantage over the competition. The growing importance of comprehensibility as a competitive advantage can also be seen in the fact that several companies from the financial sector recently use comprehensibility in their marketing campaigns. For example, the ERGO insurance company has developed a broad campaign in Germany based almost solely on comprehensibility as main advantage. Other financial institutes have reacted already and, at the moment, there are several campaigns based on comprehensibility (although, not much has changed in the communication itself until now).

Taking this background into consideration, a study was conducted to measure the comprehensibility of different bank documents. In this study, the following research questions were empirically investigated:

- How comprehensible is the communication by banks with their customers and the public in general?
- Are there any differences in comprehensibility between banks?
- What are the typical barriers to comprehensibility?
- Are there certain documents (e.g., account opening forms, General Terms and Conditions, press texts) which are particularly comprehensible or incomprehensible?
- Are there any differences in the comprehensibility of the various documents between banks?
- Has comprehensibility been compromised and, if so, can certain patterns or approaches be derived to improve these compromises?

2. The research design

The comprehensibility of communication by a total of 39 banks primarily active in retail banking was investigated. The banks included Commerzbank, Cortal Consors, Deutsche Bank, HypoVereinsbank (UniCredit Group), ING-DiBa, Postbank, Sal. Oppenheim, Targo Bank (formerly Citibank), and Sparkasse (German savings bank) as well as Volksbank and Raiffeisenbank (both are types of cooperative banks in Germany). The following types of documents were analysed for their formal comprehensibility: Account opening documentation, General Terms and Conditions, data protection declarations, press releases and newsletters. A total of 295 documents were analysed in the period from 01.04.2010 to 01.88.2010. The documents were only investigated for their formal comprehensibility. Accuracy of content was not tested. Likewise, the advisory services did not form part of the analysis. The goal of the study was to analyse the formal comprehensibility of the documents and to draw conclusions regarding their comprehensibility for customers with a normal level of education but without a business management or financial background. Investigations show that the participants understand (are able to remember and interpret correctly) formally comprehensible texts by up to 30 percent better than formally incomprehensible texts with the same content.

The comprehensibility of communication was determined in a two-stage process consisting of a quantitative and a qualitative section. The comprehensibility software, TextLab, was used for the quantitative analysis. This software programme calculates various validated readability formulae (Amstad formula, Wiener Sachtext formula WSFT, the SMOG index and the LIX readability index). Readability formulae give a very good first impression of the comprehensibility of a text. Thus, various US authorities, for instance, use the Flesch Reading Ease formula to check documents for citizens before they are published. Documents must reach a certain threshold to be regarded as comprehensible and be allowed to be published.

TextLab also calculates numerous individual text factors which are important for comprehensibility (average sentence length, average word length, percentage of words with more than six characters, percentage of nested sentences, percentage of sentences containing more than 20 words, percentage of sentences written in passive and the percentage of foreign words and abstract nouns). The higher the average sentence length, for instance, the more complex the content. Sentences of a certain length make comprehension for the reader more difficult. The optimal sentence length depends on the medium used. For example, the length of sentences in letters or on the internet should be markedly lower than, for instance, in press releases. And the greater the average word length, the more it can be assumed that there are conglomerations of complex, compound or foreign words in the text. Therefore, the frequency of longer words is also an important indicator of incomprehensibility. Sentences containing more than 20 words also compromise comprehensibility. Nested sentences or sentences written in passive language can also be barriers to an easy understanding of a document.

One of the main formulas used in the study is the Hohenheimer Comprehensibility Index. This index comprises the readability formulae and the individual values. This key performance indicator expresses the comprehensibility of communication on a scale of 0 (not at all comprehensible) to 20 (very comprehensible). To compare: texts by the German Bild newspaper achieved an average score of 16.8 points on the scale, whereas dissertations only achieved 4.2 points on the scale.

In the second stage, the documents were investigated by language experts using a guideline at the word and sentence level. The goal of the qualitative analysis was to identify typical compromises and possibly repetitive language patterns. The experts followed a set guide line. This guideline took into account the following assessment criteria: language style, specialist terminology/wording, sentence structure, sentence constructions, placement of information, as well as clarity and transparency of expression.

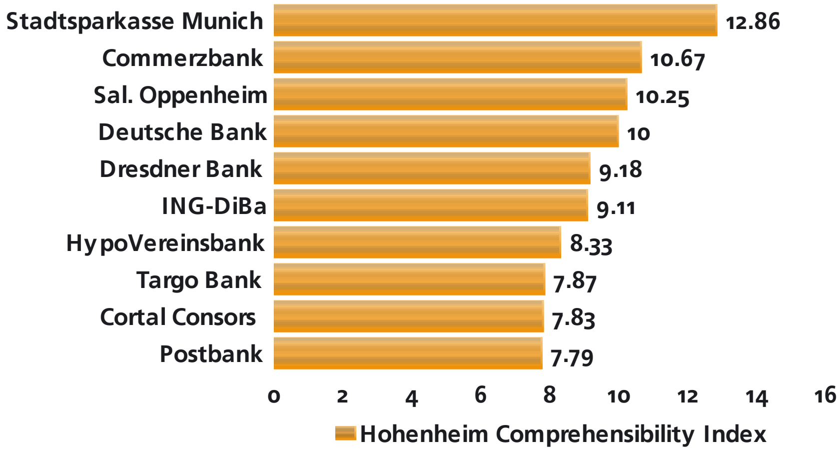
3. Results of the study

Banks do not appear to have adequately learnt their lessons from the banking crisis and the associated breakdown in trust from their customers and the public. Overall, the comprehensibility of the analyzed documents showed much room for improvement. The average comprehensibility of bank communications across all institutions and text types is 9.98 points on the Hohenheim Comprehensibility Index. The best ranked institution, a Sparkasse (German savings bank), achieved a score of 12.86. Thus, even the better ranked banks still have room for improvement. The lowest ranked institution merely achieved a comprehensibility score of 7.79 points. On the whole, it is clear that the smaller institutions with a local presence, Volksbank and Sparkasse, on average communicate more comprehensibly than the large institutions. They appear to be linguistically closer to the customer and it is no coincidence that they enjoy greater trust from the public in times of crisis. Figure 1 gives an overview of the overall comprehensibility of several selected institutions.

However, there are not only significant differences between the comprehensibility of different financial institutions, but the comprehensibility of individual text types also varies greatly. The document with the highest comprehensibility rating was the newsletter of a Volksbank: 18.08 points. However, a newsletter by Postbank also scored highly at 17.30 and landed in the Top 10. Newsletters and press releases are thus by far the most comprehensible documents. These sometimes handle complex financial subject matters, but the banks manage to present these subject matters often simply and comprehensibly. The reason for this is largely due to the fact that they are written by experienced journalists or PR experts in communications departments.

In contrast, the most incomprehensible document was the General Terms and Conditions of a local bank: 3.25 points. General Terms and Conditions and data protection declarations are also generally the most difficult to understand text types. The reason for this is not least that these types of texts must have legal certainty and thus often come directly from the le-

Figure 1: The comprehensibility of selected banks; Hohenheim Comprehensibility Index of 0 (incomprehensible) to 20 (very comprehensible)



gal department. Nonetheless, several comprehensible General Terms and Conditions proved that even legal texts don't necessarily need to be incomprehensible. Banks should become more aware that even General Terms and Conditions, data protection declarations or account opening forms can be written for a wide customer group with heterogenous educational backgrounds.

Amongst the ten most incomprehensible texts were, however, not only data protection declarations and General Terms and Conditions, but also, surprisingly, many press releases. The most incomprehensible press releases scored between 3.4 and 4.7 points: HypoVereinsbank (4.67), Deutsche Bank (4.58), Commerzbank (4.58) and SEB (3.42). This indicates a great potential for banks to further improve the communication with journalists and the general public.

Two types of texts are considered in further detail in the following: data protection declarations and press releases.

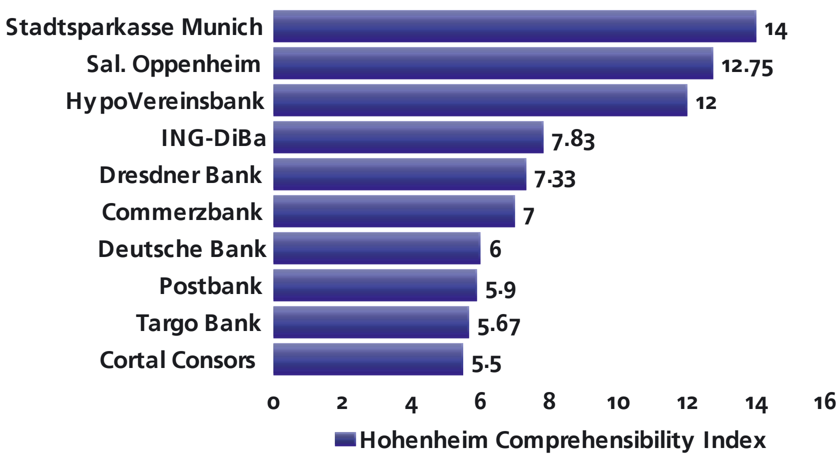
Data protection declarations

Data protection declarations directly address the customers of a bank. These are therefore documents which should be as comprehensible as possible so that even readers with a lower level of education can understand the relevant information contained therein. Consumers are highly sensitised to this subject matter, in particular given the current media hype around data security and data misuse. It can thus be assumed that more consumers today actually actively engage themselves with the data protection provisions. And, as consumer protection agencies time and again point out how carefully the handling of personal data must be checked, it can be expected that a growing number of customers will take an interest in these documents.

The average score for all data protection declarations was 7.96 points. Most data protection declarations are worded very complexly and incomprehensibly. This is partly due to the required legal certainty. However, there are significant differences between the banks (see figure 2). The excellent results achieved by the top performers prove that data protection declarations can certainly be worded comprehensibly. The lowest scoring data protection declarations, in contrast, are closer to the linguistic level of a doctoral thesis. A marked improvement by the banks is needed here, if they are not to lose more trust.

Press releases

Figure 2: The comprehensibility of data protection declarations of selected banks; Hohenheim Comprehensibility Index of 0 (incomprehensible) to 20 (very comprehensible)

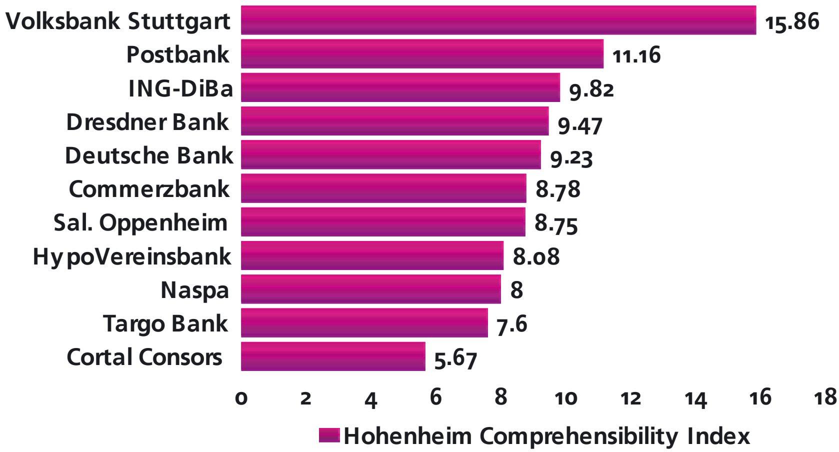


Press releases are the only document type investigated by us which are not directly addressed to the end customer. Nevertheless, press releases are an important instrument for the banks for informing the public of the banks's activities. In addition, press releases are often published on the website of a bank and can also be seen by customers there. Further, editorial offices are today suffering more from the consequences of the financial crisis. Editorial personnel are being cut back and the pressure in the editorial offices is on the increase. For this reason, press releases must be written clearly and comprehensibly as ever decreasing numbers of journalists must make their selections from an ever increasing number of press releases. Comprehensible wording therefore increases the prospects of success of a press release.

As the comprehensibility of press releases can vary greatly depending on the subject matter, five press releases from each bank were analysed. The average score for all press releases was 10.60 points on the Hohenheim Comprehensibility Index scale of 0 (incomprehensible) to 20 (very comprehensible). Thus, press releases are, on the whole, the most comprehensible type of document. The comprehensibility of the press releases, however, fluctuated sharply – between 5.67 and 15.86 points. The press releases of the banks with the best results can be classified as very comprehensible. Here it can be seen, that even complex financial subject matters can certainly be communicated comprehensibly. Nine banks achieved scores of more than 12 points for their press releases, which can be regarded as comprehensible. However, the press releases of a total of three banks had to be classified as incomprehensible (see Figure 3).

The greatest barriers to comprehensibility are long sentences, nested sentences and foreign words. The longest sentence, believe it or not, consisted of 81 words. At the end of this sentence readers can't even remember how it started. A sentence length of 20 words and up makes it difficult to retain the overall context of the sentence. Nested sentences also interrupt the reading flow and are often more difficult to understand than simple main clauses without subordinate clauses. Foreign words are part of any language, but people are often totally unaware of how to use them. Nevertheless, foreign words can be a great barrier to the comprehensibility of a text if they are used thoughtlessly and appear in too great a number. The average percentage of foreign words to all words in the documents investigated by us was 5.6 percent (min: 0 percent, max: 15.5 percent). The use of foreign words is thus certainly within the usual range. The percentage of

Figure 3: The comprehensibility of press releases of selected banks; Hohenheim Comprehensibility Index of 0 (incomprehensible) to 20 (very comprehensible)

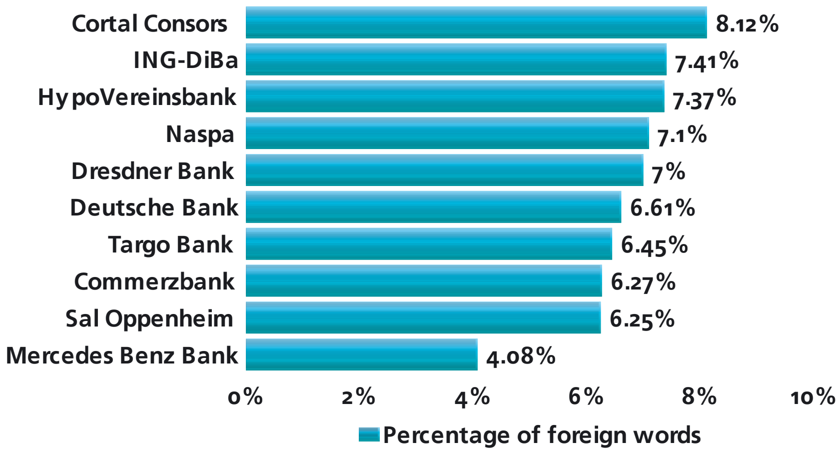


foreign words in newspaper articles is also in the region of 5 to 9 percent depending on the medium. The banks can therefore, in principle, be given a positive report here.

Foreign words are also not a compromise of comprehensibility per se. Some foreign words can be more easily understood terms such as “Kaution” [security deposit] or they can be more difficult terms such as “Bonität“ [credit rating]. However, the frequency of foreign words says a lot about the comprehensibility of a text. Are these explained? Or does the bank use foreign word after foreign word without explaining them to the layman? Again, there are large differences between the banks (see Figure 4).

Therefore, individual documents with the lowest scores prove that there is certainly potential for improvement at individual banks. Scores of 15 percent and more of foreign words indicate a very high degree of complexity and an over-use of specialist language. In some of the foreign words identified there is a glaring compromise of the comprehensibility rules. Foreign words such as “Bonität“ [credit rating] or “Votum” [vote] were used, in particular in the General Terms and Conditions and in the data protection declarations, without the relevant expert knowledge being explained to the reader. Banks should control the use of foreign

Figure 4: Percentage of foreign words in texts of selected banks



words if they want to improve communication with their customers. And if specialist language has to be used because of legal reasons, banks have to opportunity to explain the most difficult words to their readers.

4. Conclusions and recommendations

One lesson from the financial crisis is that customers should understand what banks do with their money, what the concrete provisions are that the contracts are based on and how the banks handle their data. Banks can regain the trust of their customers through easy to understand and transparent communication. However, in reality, banks often cause confusion amongst their customers with cumbersome wording. Convoluted sentences and unintelligible wording are the biggest problems identified in the study. Many banks here give away considerable potential for active, transparent and comprehensible communication with their customers.

Some of the banks included in the investigation set a good example. Many banks have documents which are comprehensibly worded. Press releases and newsletters are thus the most comprehensible document types of banks. They are usually written by journalists or PR experts and scored an average of 10.60 points on the comprehensibility scale. The ten lowest scoring banks nevertheless still show a clear improvement potential even in their press releases.
Data protection declarations, General Terms and Conditions or account opening declarations, in contrast, are worded very complexly and incom-

prehensibly. The comprehensibility of these document types often suffers due to the necessary legal certainty wording. Banks often put legal certainty before comprehensibility here. These documents are released by legal departments, not by communications departments. Customers without a high level of education could only understand the General Terms and Conditions of several institutions with difficulty according to the comprehensibility assessment (index score: 3.25).

And, almost every tenth sentence was written in the passive by the banks investigated. Passive sentences can, in certain contexts, represent a barrier for comprehensibility as they obscure who is acting. They are impersonal and create distance between the bank and its customers. The percentage of passive sentences in the press release of a local financial institution was astronomically high at more than 55 percent. In such cases, banks almost carelessly give away the opportunity to actively and transparently approach their customers.

Comprehensible communication would not even be so difficult.

- Documents which are meant for the end customer in particular must be optimised for comprehensibility. Through this, a bank can clearly signal transparency. Some of the banks in the test could be regarded as very positive examples here.
- Many banks give away a great potential for active, transparent and comprehensible communication. Sentence length, specialist language, foreign words and complex sentence constructions were identified as typical barriers. These compromises of the comprehensibility rules can be very easily controlled and do not need to occur in this form and frequency. Short sentences and avoiding nested sentences should be the rule. Foreign words and specialist terms should, where possible, be avoided or at least explained.
- Banks should, in all relevant communication departments and for all communication instruments, develop an awareness that there a number of objectively measurable language standards for comprehensible writing, and that their application benefits the reputation and can represent a competitive advantage.
- Standards and rules should be defined for a company's own corporate language. These should be assimilated in the corporate language. The most important requirements for comprehensible writing should also be integrated in the company's language guidelines. Equally important is a strategy to make the practical implementation possible.

In general, only what is understood can also convince. And convincing is necessary. A growing number of customers feel that they are no longer bound to a bank in the long term. These people have become more demanding. They want to be wooed and convinced. The same applies to the general public; the financial crisis has left deep scars of distrust in individual banks as well as in the industry as a whole. Banks should make every effort to regain this lost trust. Now, comprehensibility is surely not the most important means to rebuild the lost trust, reputation and the good name; actions and transparent products are necessary for this. But, comprehensibility can nevertheless play an important role. Banks which communicate comprehensibly signal to their customers, „We are taking you seriously. And we are interested in dialogue.“ That would indeed be a start. As it is, some banks are setting an example.

2. Accounting: Transparency is Key to Regain Trust

2.1. The Role of IFRSs and XBRL in Enhancing Transparency in Financial Reporting

by Olivier Servais, Maciej Piechocki[1]

Introduction

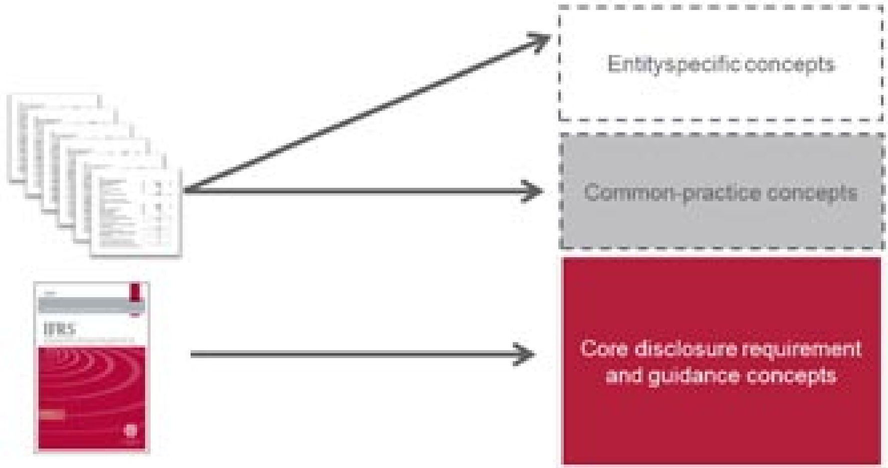
In the current economic climate where the after-shocks of the last great meltdown continue to reverberate, few people would argue against the need for transparency in financial reporting. But what is meant by financial reporting transparency? In the IFRS Conceptual Framework it is characterised by "the attributes that make the information provided in financial statements useful to users … understandability, relevance, reliability and comparability" (IFRS Conceptual Framework 24).

Through its objective to develop a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles, the IFRS Foundation and its standard-setting body – the IASB (International Accounting Standards Board) – aims to support this transparency by providing the world's integrating capital markets with a common language for financial reporting. However, the degree to which business information is understandable, relevant, reliable and comparable is dependent not only on the content and data within, but also the external mechanism used to transmit the information. As the shift towards online communication mediums continues to feed the growing information exchange demands of an expanding, global audience, online technologies such as XBRL (eXtensible Business Reporting Language) have a role to play in enhancing the transparency of financial information communicated to users.

Fulfilling disclosure requirements and communicating with the IFRS Taxonomy

XBRL was developed specifically to communicate information between businesses and users of financial information by providing a common, electronic format for business reporting. Applying universally accepted mark-up tags that are defined in a central taxonomy to items of business information ensures that the understandability, reliability and comparability of the information (i.e., its content) is maintained when the information is transmitted. The fact that XBRL tags are extensible and can be applied to a range of information – even if it is not necessarily IFRS-related – permits additional information which is not necessarily contained in the taxonomy to be reported, thereby ensuring that all relevant information can disclosed. By maintaining the integrity and comparability of business information, XBRL – likes IFRSs – helps to

Chart 1: Taxonomy Composition



standardise business information, therefore IFRSs and XBRL form a perfect partnership for enhancing transparency in financial reporting. The IFRS Foundation recognised the potential impact that XBRL could have on financial reporting. The Foundation also realised that if XBRL were applied in conjunction with IFRSs, it could improve access for users to financial information and could also support IFRS adoption and implementation. The Foundation therefore launched the IFRS XBRL initiative in 2001 to create and publish an XBRL taxonomy containing tags for all IFRS disclosures, known as the IFRS Taxonomy. In order to ensure that the information transmitted using the IFRS Taxonomy is understandable, relevant, reliable and comparable, three broad categories of disclosures can be reported using the taxonomy – IFRS disclosures, common-practice disclosures and entity-specific disclosures.

In terms of IFRS disclosures, the IFRS Taxonomy is the XBRL representation of the IFRSs, including IASs (International Accounting Standards) and the IFRS for SMEs (Small and Medium-sized Entities), issued by the IASB. The taxonomy is developed following a standard approach, whereby the content of the taxonomy is developed based upon each IFRS in turn, on a standard-by-standard basis (e.g., IAS 1, IAS 2, IAS 3 … IFRS 1, IFRS 2, etc). By following this approach, the taxonomy remains consistent with IFRSs and accurately reflects IFRS disclosures in terms of granularity of detail and disclosure characteristics.

IFRS reporting is largely disclosure-driven, and shifts in reporting practice gradually become manifest via changes in an IFRS. While these changes are necessary in order for financial information to remain relevant and understandable, they can cause problems in terms of comparability. However, XBRL taxonomies are able to support this comparability by enabling entities to react to changes in disclosures whilst also supporting continuity in the face of such changes through automated change management (i.e. versioning) information. This also enables users of financial information to see, understand and react to changes in information, thereby allowing them to identify comparability in financial models.

In order for information that is truly relevant and understandable to be reported, the IFRS Taxonomy enables entities to report additional, IFRS or non-IFRS-related information that is necessary to understand their financial statements. This information can largely be classified as arising from either common-practice or from other entity-specific requirements, also as disclosing information required by a local regulator. For this reason, the IFRS Taxonomy has been developed as an open, core taxonomy which an entity can tailor to its specific needs

Chart 2: Disclosure of Inventories

by adding its own tags. By allowing entities to report a range of information – whether related to IFRSs disclosure requirements, common-practice or entity-specific – the IFRS Taxonomy ensures that entities are able to meet compliance requirements whilst also disclosing information that is relevant and which provides a "true and fair" view.

Comparability and Transparency with the IFRS Taxonomy

Information comparability has already been briefly discussed, but in the specific context of continuity in an entity's reporting, i.e. how to ensure that company A's 2010 financial statements are comparable with its 2011 statements. However another aspect of comparability that should be considered is inter-company comparability. The IFRS Conceptual Framework states the necessity of both aspects of comparability: "Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities" (IFRS Conceptual Framework 39).

However the IFRS Conceptual Framework also states that "the need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards" (IFRS Conceptual Framework 41). This leads to full understanding of the notion of extensibility which is a characteristics of the XBRL in general and IFRS Taxonomy in particular. While the IFRS Taxonomy represents central repository of tags, it allows for additional tags which represents entity disclosures. This should not be confused with reporting according to a form. In other words the IFRS Taxonomy allows for comparability on the level of disclosure requirements in the IFRS. In the same time being highly extensible does not enforce uniformity. It is also important to mention that the comparability in reporting according to the IFRS Taxonomy goes beyond simple labelling of line items in financial statements. It will often happen that different entities will label the same line item differently (i.e., net income, profit (loss)). If numbers reported for such line item are tagged with the IFRS Taxonomy tag of "ProfitLoss" they remain comparable while allowing for entity specific naming. It created also possibilities of comparing financial statements from different jurisdictions. If entities in Poland will report "Wynik całkowity", entities in Germany "Geschäftsergebnis" and in Japan 純利益(純損失) but all will use the IFRS Taxonomy tag of "Profit-Loss" the comparability will remain maintained.

High quality, accepted and implemented IFRS Taxonomy is a critical requirement for comparability and transparency (overcoming the issue of distributed data pools). XBRL role should not be overstated - this is merely a transport standard to get financial information from A to B (between computer systems). What is however often underestimated is the role of XBRL taxonomies and the IFRS Taxonomy in particular. The IFRS Taxonomy represents baseline for comparability of financial information reported in compliance with IFRSs. It organises concepts representing all disclosure requirements, thus becoming a knowledge base. Even when financial information is transferred to analytical systems and leaves XBRL format, there will always be a need for using the taxonomy to understand what such financial information expresses. The interesting aspect of the IFRS Taxonomy is that as a central "knowledge base it does not enforces existence of a central financial reports repository (global EDGAR). Indeed it allows for comparability (and thus transparency) between financial reports (in XBRL) available in distributed data pools. For example XBRL IFRS Taxonomy filing in EDGAR can be easily compared with XBRL IFRS Taxonomy filing in Chilean or South African repository. This is opportunity for global capital markets to truly have access to globally comparable and consistent financial information.

Conclusions

XBRL as a reporting mechanism in its own right has great potential to improve business reporting and to deliver better, faster, cheaper business information. However the mechanism can only be as effective as the information that it is being used to report, and in the case of financial reporting specifically it is when XBRL is combined with IFRSs, as it is in the IFRS Taxonomy, that the true potential for financial information transparency (understandability, relevancy, reliability and comparability) can be truly realized.

1 The IFRS Foundation is an independent, not-for-profit private sector organisation working in the public interest. Its main mission, through its standard-setting body – the IASB – is to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs). The opinions expressed in this document are those of the authors and do not necessarily reflect the views of the IASB or the IFRS Foundation.

2.2. Natural Capital: The Finance Sector & Financial Reporting – Catalysing Action?

by Kurt Ramin and Cornelis Reiman

Sustainability and the Finance Sector

Given the widespread impact of the recent global financial crisis, increasingly, the finance sector is now in line to be affected by factors of sustainability, as well as intensifying social and environmental risks and impacts. As a direct consequence, more attention must be paid by financial institutions to sustainability programs that are shaped and driven by factors such as corporate strategies, policies, goals and initiatives. In turn, these are based on drivers of economic, social and environmental risk, as well as, in addition to reputation, financial return and natural resources. Sustainability programs ensure that, amid environmental, social and economic uncertainty, an organization is able to adapt and, thereby, remain viable for the long-term interest of its owners.

Financial reporting systems will play a major part in watching the sector's progress towards sustainable policy adoption. This will include IT system integrations, making financial flows more transparent and increasing pressure for implementing a less speculative global currency model. Appropriate accounting and reporting systems are needed urgently. Additionally, these must have a global reach in tracking and valuing financial products if the financial sector is to play a critical role as a catalyst and integrator in moving other global financial reporting initiatives forward.

A changing agenda for financial institutions

We now understand the intellectual argument that natural capital (land, air, water, and living organisms in particular) provides significant value to society and the economy. But, it is not recognised or accounted for accordingly. What does this mean for the finance sector? Let's explore the type of risks that financial institutions should begin to think about when it comes to natural capital; these are:

Credit risks: The default of investments can be caused by risks associated with natural capital, and this can also prompt inaccurate information affecting counterparts. Collateral risk is central to this, as banks don't have the means of recognising the loss of natural capital and what this means in relation to their investments.

Operational risks: These are most serious when it comes to an acceleration of natural disasters or the effects of ecological degradation on business outputs, such as agriculture. Losses are a probable outcome.

Reputation risks: being associated with financing an entity that is involved in major ecological liabilities bears increased risk. Once a financial institution loses its reputation in this manner, it is very difficult to build that back up.

These risks, and others, are recognised inherently by the 2010 UN-sponsored study on "The Economics of Ecosystems and Biodiversity" (also referred to as the TEEB initiative - see www.teebweb.org), Even so, the finance sector must pioneer fundamental changes in how it estimates and analyzes risks. It is more than likely that some within the finance sector will be hit harder than others. The insurance sector represents a particular case in point where exposure to natural capital risk is more pronounced, especially due to accelerating climate and environmental risks.

It must be said that the lack of agreement on valuation mechanisms and metrics are a barrier. Yet, banks today use a wide range of instruments. These must be brought together in a systematic way, such as in a financial sector tool kit that addresses natural capital. This would also identify good examples of the financial instruments, the institutional processes, and the valuation mechanisms that are already implemented.

Key innovation trends in the sector

Investors can play a forward-thinking role in treating natural capital issues as drivers of shareholder value. There are several areas where some innovation is taking place and where effort is needed by the industry to accelerate necessary change.

Benchmarking

The Natural Value Initiative (see www.naturalvalueinitiative.org) is a leading example of benchmarking and has found that only one out of 31 companies analyzed in the food, beverage and tobacco sectors were particularly mature in their approach to natural capital. Benchmarking companies in the responsible investment research industry are developing fast. But, these entities are trying to cover a large amount of companies by way of predominantly public information that is available. It is noteworthy that a study released by the UN-backed Principles for Responsible Investment (PRI) and the UN Environment Programme Finance Initiative (UNEP FI) estimated that global environmental damage was caused by human activity in 2008 represented a monetary value of $6.6 trillion, with this being equivalent to 11% of global GDP. Major financial companies, such as Bloomberg, Thomson Reuters Asset4, Risk Analytics, are now getting into this space. Even so, attention also needs to be given to what is being benchmarked as different companies are good at varying elements. Many smaller entities, such as AccountAbility (see www.accountability.org) and Gaia-Metrics (see www.gaia-metrics.com) are helping clients to benchmark information or provide standards and tools. In turn, this leads to better reports.

Valuation and Risk

Banks, the investment sector and insurance companies have developed excellent risk and valuation models. The various environmental risk factors must be embedded into the general risk policies, with this needing to be beyond what, so far, is kept within the boundaries of project finance (for example, Equator Principles). Frankly, there is still too much focus on externalities. Consequently, valuations must be more object, entity and business model-centered.

Awareness

Reputation is still the leading driver of change in the finance sector. Examples of ecosystem failures as drivers of change are rare. Civil society and NGOs are playing an important role in highlighting the issue. But their strategies could also be more effective at targeting the right stories related to risk and opportunity for the finance sector. It is vital, therefore, to bring an operational risk perspective, as well as hard business case numbers to the story, and to any associated campaigning. It stands to reason that an individual event, such as the BP oil spill in the Gulf of Mexico, can have a significant impact upon single investments and related industries.

Knowledge barriers

There is a need to accelerate translation of the biodiversity and natural capital issue into business language and associated cultures. A key consideration here is that the older generation of financiers today does not fully understand, or relate to, the language of ecologists, climatologists and earth scientists. In some areas of the finance sector, the type of scientific data that is developed by assorted earth scientists can cause financial analysts to feel discomfort, confusion and apathy. In relation to this issue, North American Electric Reliability Corporation (see www.nerc.com) is looking at collaboration between the academic sector and finance sector on biodiversity information. There is also an urgent need to bridge the worlds of science-based policy on ecological infrastructures (for instance, what is the optimum level of ecological balance?) and financial investment (for instance, how does this ecological equilibrium translate onto economic and financial values?).

Accounting & Reporting

Financial reporting is reliant on underpinning standards and there is also a need for standardization in how natural capital accounts are measured and integrated into financial statements. NGOs and investors have different ways of doing this, thereby making it difficult to know if we are comparing like with like.

Several models, such as that of the Global Reporting Initiative (GRI), are now proposing solutions to the disclosure and reporting of natural capital accounts (see www.gri.org), with this based on sustainability. However, these efforts need to engage more thoroughly with accounting bodies and financial regulators in order to experiment with enhancing the regulations and standards. One huge issue here is that the public sector (which has most nature assets under management) doesn't report consistently. Also, while International Public Sector Accounting Standards (IPSAS) are starting to appear in public sector reporting (see www.ifac.org), it is a very slow process of adoption. Note that IPSAS are based on globally accepted International Financial Reporting Standards (IFRS) and there is no real reason why the necessary implementation of appropriate standards cannot be accelerated. Furthermore, adoption of IPSAS would have an enormous and positive effect on modernizing totally outdated, and fragmented income tax laws in most countries. One other standard that could benefit considerably from the modernization of standards is the UN System of National Accounts (UN-SNA or SNA) that, currently, focuses too much on boundary definitions instead of object tracking and valuations.

As a positive sign of possible progress, the need to have more global overarching standards is already identified with the emergence of the International Integrated Reporting Committee initiative (see www.integratedreporting.org).

Financial institutions, in particular global banks, with their worldwide operations and huge capital asset base, could serve as a driver and catalyst to utilize emerging reporting systems such as the GRI. By so doing, the banks would serve as a leading example in terms of better integrated reporting and a new way forward in relation to financial reporting.
In effect, financial institutions are trailblazers in utilizing the fair value model and, with it, these entities can lead worldwide accounting convergence. Certainly, the debate around fair value accounting has highlighted the need for global harmonisation of asset and liability valuations. However, banks are weak in object tracking, as is evidenced by recent mortgage failures where it was difficult

Table 1: Largest Banks by Asset Size, 2009

Rank	Bank	Country	Total Assets ($B)	Date
1	BNP Paribus	France	2,964	12/31/09
2	Royal Bank of Scotland	UK	2,747	12/31/09
3	HSBC Holdings	UK	2,364	12/31/09
4	Credit Agricole	France	2,243	12/31/09
5	Barclays	UK	2,233	12/31/09
6	Bank of America	United States	2,233	12/31/09
7	Mitsubishi UFJ Financial	Japan	2,196	3/31/10
8	Deutsche Bank	Germany	2,162	12/31/09
9	JP Morgan Chase	United States	2,032	12/31/09
10	Citigroup	United States	1,857	12/31/09

Source: Global Finance Magazine 2010

for banks to trace obligations back to the original owners through the intervening multiple layers of securitization.

In this regard, consider Table 1 in which the massive asset holdings of global banks are shown. Of particular interest is the asset level of Deutsche Bank, which has fallen by nearly a trillion US Dollars from $3.1 trillion in 2008, to $2.2 trillion in 2009. Remarkably, there is no reasonable explanation provided in the annual report or other pronouncements for such a significant reduction. This is indicative of weak accounting regulations in that a sizeable bank can avoid any justification for a more than obvious drop in its assets.

IT Infrastructure

Financial institutions are proven leaders in developing global risk models, but demonstrate less success in using global IT platforms similar to what ERP system packages have done for the industrial sector.

While this is cause for concern, and for necessary change, there is increasing pressure for worldwide system improvements (for example, see the daily news on system changes and improvements on www.finextra.com and the just-published Senior Supervisors Group Issues Report on Risk Appetite Frameworks and IT Infrastructure, (see www.sec.gov/news/digest/2010/dig122310.htm). Global IT structures will lead to essential consolidation in the finance sector and new business models will emerge as a direct consequence. Hopefully, this will result in less speculation (particularly in relation to currencies) and enhance trust in reported numbers generated by the sector.

In addition, financial institutions can learn from industrial applications of object tracking and support the development and improvements in valuation standards. For instance, there are ones promoted by the International Valuation Standards Council (see www.ivsc.org). The separation of objects and valuation could, in effect, be a new way forward in financial reporting.

Financial Reporting

Regarding the separation of object tracking and valuation, it is worthwhile to compare the financial statements of an industrial/consumer goods company, such as BDF Nivea (BDF), and a financial institution, such as Deutsche Bank (DB) in respect to their reporting on people, products, infrastructure, financial assets and intangibles. It is noteworthy that both are IFRS-reporting companies.

Besides the relative size and volume of their presentations (2009 Annual Report: DB: 434 pages; BDF: 134 pages) a comparison indicates that the major differences in their reporting are:

- Better GRI and sustainability, as well as product and infrastructure reporting, by BDF (Object tracking);
- More sophisticated reporting on financial instruments and currency reporting by DB (Value reporting);
- Weak metrics on people and intangible reporting by both companies (Object reporting).

Separating Unit and Value Flow in the Supply Chain

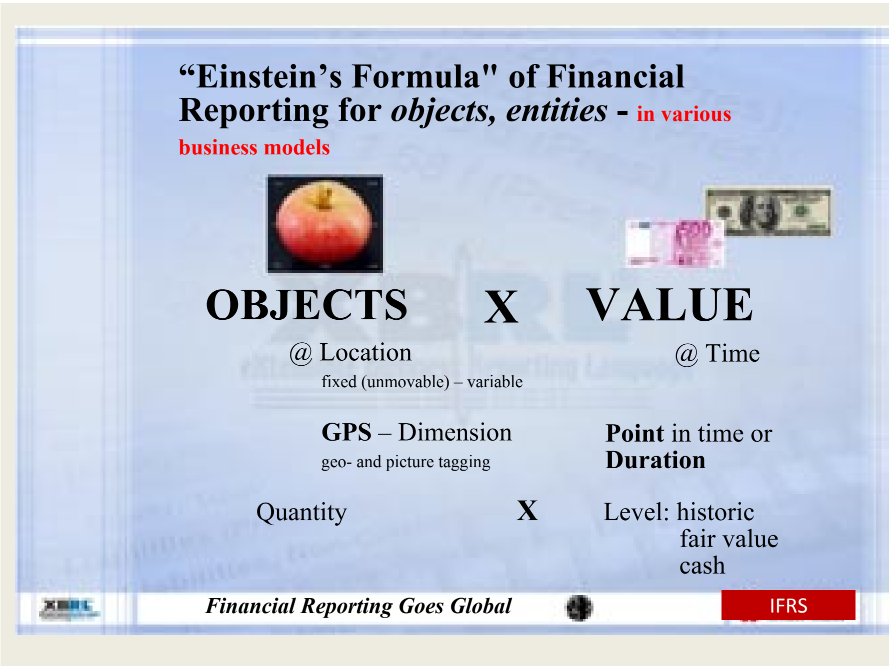
The mixed attribute model, which pulls together historical and fair values in the same financial statement, (see the United States Securities Exchange Commission report to Congress, www.sec.gov/news/studies/2008/marktomarket123008.pdf, on page A-7), is one of the culprits in making financial reporting difficult to understand. Separating unit flow and value flow would be one way forward in order to bridge business reporting and reporting on nature. On a micro-level, there is much more *unit data* available regarding ecosystems and biodiversity than there is *value data*. In business, particularly in the finance world, it is the other way around as there is greater focus on value flow in order to capture risk and uncertainty. In this regard, consider huge general reserves and reinsurance of insurance companies.

'Einstein's Formula' for Financial Reporting

It is worth contemplating, at this point of the discussion, that electronic transfer and tracking systems (especially XBRL in combination with RFID, GPS and other useful applications) create a global, intelligent, chart of accounts that can help to make information, whether business-related or otherwise, more useful for stakeholder purposes (see Figure 1).

With modern technology, such as geo-tagging and photo-mechanical object recognition we are now able to track and find any number of objects in the business supply chain. Thereby, relativity becomes apparent when any objects are identified and monitored. Particularly, all identifiable objects can be aligned, and valued, in order to support improved decision making. Whether objects are apples, customers, capital items, stock holdings or deliveries, all of these

Figure 1: Modern Technology Enables Improved Decision Making



can be monitored and managed with considerable ease.

Even so, there is a need for business entities to obey a couple of rules to set the boundaries. For instance, every entity must make an individual decision on how to define objects *within their entity*. Thus, objects entering and leaving the entity could have different object definitions. Some industries already have defined object definitions for their entire supply chain (for example, RosettaNet). Outsourcing and cloud-computing are other ways to coordinate object definitions within industries. Unmovable (fixed) objects can employ different tracking devices than movable (variable) objects.

In addition, objects can be broken down into the following business/financial reporting areas:

- **People** (number of people x rates, benefits, etc.)
- **Tangible assets and infrastructure** (number of cash-generating units x fair value, value in use)
- **Products and Services** (Stock-keeping units x price)
- **Financial assets and liabilities** (contracts, currency units x fair value)
- **Intangibles and Communication** (identifiable units x fair value)

These objects can be aligned to valuation files (such as fair values, historical costs and cash flow points). At a particular point in time and when required, the objects can be multiplied with the appropriate value files so as to avoid mixing apples and oranges, as occurs in the mixed attribute model.

The above-mentioned segregation lends itself well to the alignment of biodiversity and ecosystem data with financial and business information. Dependencies and any impact on business, such as from the use of subsoil assets, as well as the pollution of water, air and earth, could be better explained. Instead of the current silo approach, business reporting and reporting on biodiversity and ecosystems could be integrated. Sustainability reporting, currently, is still something of a stepchild to other reporting needs as it lacks timeliness, seriousness and enforcement.

Aligning Financial / Business Reporting and Sustainability Reporting through Disclosure

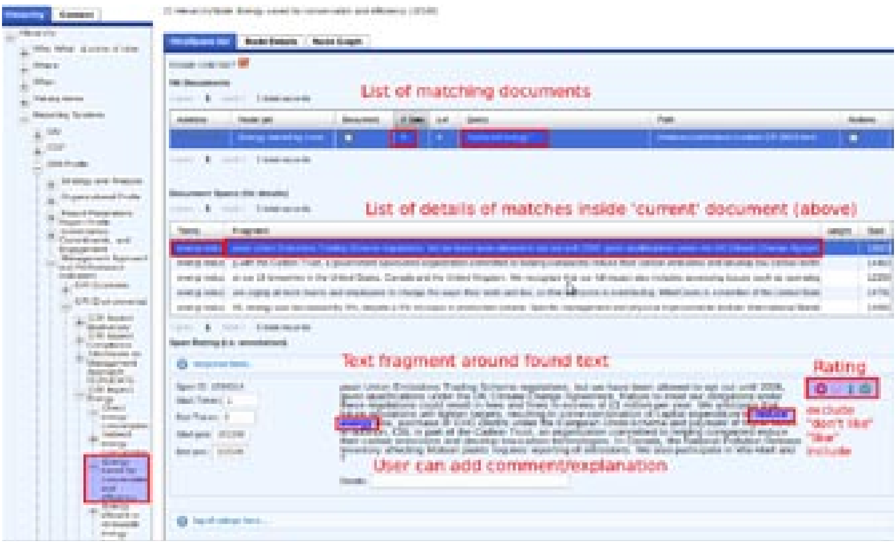
Most often materials, resources and other valuable information is spread widely within an organisation, as well as externally. Once all of this is organized into meaningful segments (such as the aforesaid objects and sub-objects) the associated unit and value flow can be analysed. Pieces of information (now referred to as objects) that might be difficult to explain could, at a minimum, be aligned to a particular sector (for example, social networks and their influence in the people section of any so-called financial report). Then, an indicative value can be given as an attribute in the form of a reporting disclosure.

Modern content analysis tools, such as Gaia Metrics SDR Data Prep, can help us to find, sort, and adjust information in internal company documents as well external publications, and align them (in terms of who, where, and when) in accordance with a meaningful taxonomy or reporting system. An example of this systematic and effective approach is provided in figure 2.

As the heading in this figure suggests, this application involves a human interface in ranking and flagging the results of any search. The left side of the screen shows a tree-view of the hierarchy for basic navigation.

In the main part of the screen, the top table shows a list of hits of any search, such as documents that contain the concept in the search parameters related to the selected tree to the left. The second (and middle) table shows the details of where, and how many times the given concept occurs in the hit document. This is also known as a span. Finally, the

Figure 2: Content Analysis with Human Filtering



lower area shows details about the selected span as is summarized in the middle table. This is where a human filter can score the span, and also add a description for why they scored it the way they did. That adds to the effectiveness of subsequent searches, increasingly so over time and through additional interrogations of all objects and related information.

Call for Action – the way forward

Financial institutions are going through major changes in relation to determining the current usefulness and future form of their business models. In the process, these significant and influential entities must pay more attention to sustainability reporting. Consider that nature, with its plentiful amounts of metrics, and financial institutions, with their extensive knowledge as to risks assessment and valuations, can become a powerful combination, as well as a catalysing factor in improving financial reporting.

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2.3. Integrated Reporting – A Means for Corporations to Become Socially Responsible and Accountable

by Liv Apneseth Watson

The BP oil spill that leaked more than 19 million barrels of oil into the Gulf of Mexico made it readily apparent that our existing system for corporate reporting has failed shareholders and stakeholders alike in evaluating a company's risk. The traditional reporting of companies consisted primarily of balance sheets, income statements and the accompanying directors' report that together outlines whether a company's performance is not measuring up. Some go as far as to say that the over-consumption of finite natural resources, coupled with the very real risk of catastrophic corporate accidents and climate change, is the greatest challenge facing our world.

Since BP crisis companies find themselves in the midst of a rapid global transformation with increased demand to perform, not only financially, but also as a good corporate citizen that reports its results to stakeholders. The notion of companies looking beyond profits to their role in society and reporting it to stakeholders is generally termed Corporate Social Responsibility (CSR) reporting. Weaving these reports together into one report is referred to as integrated reporting. That is, integrated reporting refers to the integrated representation of a company's performance in terms of both financial and non-financial results, and many smart companies are providing integrated reports as a means to seek new business opportunities, safeguard reputation, maximize competitive advantage and mitigate operations risk.

"To make our economy sustainable we have to relearn everything we have learnt from the past. That means making more from less and ensuring that governance, strategy and sustainability are inseparable. Integrated Reporting builds on the practice of Financial Reporting, and Environmental, Social and Governance (ESG)- or Corporate Social Responsible (CRS)- Reporting, and equips companies to strategically manage their operations, brand and reputation to stakeholders and be better prepared to manage any risk that may compromise the long-term sustainability of the business."

Professor Mervyn King, Chairman of the Global Reporting Initiative, (GRI)

According to Klaus Schwab, the Executive Chair of the World Economic Forum Global, corporate global citizenship means that companies must not only be engaged with stakeholders but be stakeholders themselves alongside governments and civil society. His reasoning is that companies depend on global development, which in turn relies on stability and increased prosperity so it should be in their direct interest to help improve the state of the world. This thinking among global leaders today is increasingly driving companies to produce, mostly on an annual voluntary basis, corporate social responsibility reports. Over the last few years a selected number of companies have started integrating CSR reporting into their annual reports. Integrated reporting is part of the shift in business responsibility towards becoming corporate global citizens. Integrated reporting therefore provides greater context for performance data, clarifies how sustainability fits into the company's DNA, and helps embed sustainability into company decision making.

There is increasing demand from international investors, accounting bodies, governments and other stakeholders for integrated reporting. The best illustration of this trend is the growing number of organizations and public and private initiatives that make CSR reporting their business.

Some of these organizations are:

- **Principles for Responsible Investment (PRI)** represents signatories to the United Nations' Principles for Responsible Investment (PRI). Launched in 2005, the PRI today accounts for more than 560 global investment institutions with more than $18 trillion in assets under management. PRI signatories pledge to integrate consideration of CSR issues into investment decisions and ownership practices. They recognize that social and environmental issues can be material to the financial outlook of a company and, therefore, to shareholder value.

- **Ceres**, and advocacy non-governmental organization (NGOs) is on the green bandwagon and works with investors worldwide to improve corporate and public policies on climate change and other environmental, social, and corporate governance issues. As part of this mission, Ceres launched and coordinates the Investor Network on Climate Risk (INCR), an alliance of more than 90 institutional investors and financial firms that collectively manage nearly $10 trillion in assets to influence companies to report CSR reports.

- **AccountAbility** is an organization that has developed the AA1000 series of standards that are principles based to help organizations become more accountable, responsible and sustainable. They address issues affecting governance, business models and organizational strategy, as well as providing operational guidance on sustainability assurance and stakeholder engagement. The AA1000 standards are designed for the amalgamated thinking required by the low carbon and green economy, and they support integrated reporting and assurance.

- **The Global Reporting Initiative (GRI)** provides a framework for companies and organizations on sustainability disclosure. Its vision is that disclosure on economic, environmental and social performance become as commonplace and comparable as financial reporting and as important to organizational success. The GRI Consortium is a network-based organization that has pioneered the development of the world's most widely used sustainability reporting framework and is committed to its continuous improvement and application. More than 1,000 organizations globally declare that they use the GRI Guidelines for their sustainability reporting, including 3M, Cisco Systems, Citigroup, Dell, Eli Lilly, Intel, General Electric, Procter & Gamble, Walmart and United Technologies.

- **Corporate Responsibility Index (CRI):** These are being developed in many parts of the world by stock exchanges, NGOs, and the public and private sector; all with the vision of improving corporate responsibility by providing a systematic process that assists companies in identifying their non-financial risks. The Dow Jones Sustainability INdex and the FTSE4 Good are used largely as socially responsible investment indices.

- **The WICI, The World's Business Reporting Network** (www.wici-global.com) is a private/public sector partnership for improving the reporting of intellectual assets and key performance indicators that are of interest to shareholders and other stakeholders. On October 16, 2008 WICI released its first version of a comprehensive information framework and XBRL taxonomy to help companies better communicate with their investors and other stakeholders about business strategy and performance.

- **The Prince's Accounting for Sustainability Project (A4S):** His Royal Highness the Prince of Wales himself leads this important project. Accounting for Sustainability is a project that brings organizations and other key stakeholders together for the purpose of developing practical tools that enable environmental and social performance to be better connected with strategy and financial performance and, thereby, embedded into day-to-day operations and decision making.

"The case for globally consistent financial reporting standards is well understood and accepted. It is appropriate to apply the same global approach to other aspects of corporate reporting. This initiative represents an important step on that journey."

Sir David Tweedie, Chairman of the International Accounting Standards Board

- **International Integrated Reporting Committee (IIRC):** On August 2, 2010, The Prince's Accounting for Sustainability Project and the Global Reporting Initiative announced the formation of the International Integrated Reporting Committee. The committee's bold vision is to bring forward a global comparable framework for CSR reporting. They plan to present this global initiative to the G-20 Meeting in Paris in 2011.

  The IIRC has been created to respond to the need for a concise, clear, comprehensive and comparable integrated global reporting framework that is structured around the organization's strategic objectives, its governance and business model and that integrates both material financial and non-financial information.

  The objectives for an integrated reporting framework are to:
  - support the information needs of long-term investors by showing the broader and longer-term consequences of decision making;
  - reflect the interconnections between environmental, social, governance and financial factors in decisions that affect long-term performance and conditions, making clear the link between sustainability and economic value;
  - provide the necessary framework for environmental and social factors to be taken into account systematically in reporting and decision making;
  - rebalance performance metrics away from an undue emphasis on short-term financial performance; and
  - bring reporting closer to the information used by management to run the business on a day-to-day basis. (Source: International Integrated Reporting Committee (IIRC)).

All these organizations collectively have a huge influence on corporate

"I believe we will look back on the creation of this Committee as a turning point in the development of corporate reporting."

Jane Diplock, Chairman of the New Zealand Securities Commission and Executive Committee of the International Organization of Securities Commissions (IOSCO)

behavior and policy makers. From Southwest Airlines to United Technologies to Walmart companies of all types and sizes are voluntarily communicating integrated information to stakeholders about their business's impact on the environment. Stock exchanges are starting to incorporate mandatory CSR disclosure standards the same way that financial reporting is a requirement for all companies. The 2010 UN Sustainable Stock Exchanges event in China focused on how stock exchanges and key stakeholders can improve CSR disclosure and performance of listed companies, either through voluntary exchange-led initiatives or regulation. The conclusion of the meeting was that there is a strong business case for stock exchanges to strengthen CSR disclosure requirements. Starting on June 1, 2010, all 450 companies listed on the Johannesburg Stock Exchange will be required to publish an integrated report or explain why they are not doing so. Market evidence already exists that indicates the value investors, analysts and other stakeholders place on important non-financial information (e.g., Environmental, Social and Governance or ESG data) that gives a more comprehensive view of an organization's performance. Recently, over 250 of the world's largest institutional investors, representing over $15 trillion in combined assets under management, demonstrated their commitment through the UNPRI to invest in companies that follow good sustainability and ESG practices. As we can see, there are potentially several reasons for companies to go green and produce integrated reports with the ultimate goal of becoming socially responsible and accountable to all stakeholders.

2.4. The Case for Integrated Reporting

by Michael P. Krzus

Background

Reporting matters. When done right, reporting gives stakeholders a window through which to view the heart and soul of a company. Reporting provides insight into how a company views itself and its role in society. It communicates a company's performance, both good and bad. It creates commitments to improve in the future, both through specific targets and in response to the feedback a company gets from all of its stakeholders based on the information it makes available to them.

The business reporting model, as we know it today, is fraught with shortcomings. The model is rooted in the Great Depression, a time when hard assets such as factories, equipment and land created value. Today, value and risk arise from, among other things, innovation, people, customer loyalty, leadership, technological change, supply chains and business partners, and finite natural resources. There are too many companies that view reporting as a compliance exercise, rather than a stakeholder communications and engagement tool. Companies frequently fail to provide enough of the information used for decision-making. Discussion of strategy, plans, opportunities, and risks is often boilerplate. There is not enough robust disclosure of financial and nonfinancial key performance indicators and contextual narrative around environmental, social and governance issues.

The encouraging news is that a nascent trend, but a trend nonetheless, towards better reporting is coming to light. Companies in diverse sectors and based in different parts of the world are starting to adopt integrated reporting. Novo Nordisk In Denmark, Altron in South Africa, Natura in Brazil, American Electric Power in the US, Takeda Pharmaceutical in Japan, and Philips in The Netherlands, to name only a few companies, have published integrated financial and sustainability reports. These companies know integrated reporting is the best way to communicate with stakeholders on how well they are executing strategies that integrate sustainability into the company's core operations and processes.

The case for integrated reporting

Why are companies voluntarily preparing integrated reports even though the process requires substantial work and collaboration amongst groups that often operate in silos? Perhaps it is enlightened self-interest or even the foresight to anticipate market forces or regulatory actions.

In *One Report: Integrated Reporting for a Sustainable Strategy*,[1] Robert G. Eccles and I asserted, "Practicing integrated reporting brings four major benefits to the company. First, it provides greater clarity about relationships and commitments. Second, it leads to better decisions. Third, it deepens engagement with all stakeholders. Fourth, it lowers reputational risk." Each of these benefits can be summarized as follows:

- There will be greater clarity about the trade-offs that must be made as an entity seeks to balance the need for long-term viability—of both the business itself and the world it relies on to create value—with the demands for short-term competitiveness and profitability.
- Deeper understanding of the relationships between financial and nonfinancial performance will drive better informed decisions and lead to more efficient and effective use of capital and other resources.
- Deeper engagement by an entity with a wider range of stakeholders will promote a better understanding within a company and across stakeholder groups about how their interests are related.
- Improved risk management processes will increase the likelihood that the company is viable over the long term as society's values change.

In addition, Robert Eccles and Kyle Armbrester make a persuasive case for what drives companies to adopt integrated reporting in a forthcoming paper, *Integrated Reporting in the Cloud.*[2] Eccles and Armbrester not only cite three primary benefits of integrated reporting, internal benefits, external market benefits, and managing regulatory risk, but also provide a detailed drill-down into each of these points. This soon to be released paper also looks beyond glossy paper reports and talks about how cloud computing can enable the adoption of integrated reporting.

The emerging integrated reporting movement

A growing number of progressive companies have seized the initiative to adopt integrated reporting, and they are to be commended for their efforts. However, absent a broader and organized movement, the adoption of integrated reporting will be slow.

In August 2010, The Prince's Accounting for Sustainability Project (www.accountingforsustainability.org) and the Global Reporting Initiative (www.globalreporting.org) jointly announced the formation of the International Integrated Reporting Committee, or IIRC (www.integrat-

edreporting.org). The role of the IIRC is to:

1. Raise awareness of this issue and develop a consensus among governments, listing authorities, businesses, investors, accounting bodies, and standard setters for the best way to address it.
2. Develop an overarching integrated reporting framework setting out the scope of integrated reporting and its key components.
3. Identify priority areas where additional work is needed and provide a plan for development.
4. Consider whether standards in this area should be voluntary or mandatory and facilitate collaboration between standard-setters and convergence in the standards needed to underpin integrated reporting.
5. Promote the adoption of integrated reporting by relevant regulators and report preparers.

The IIRC is preparing a discussion paper for release in June 2011. The results of the consultation will be used to develop integrated reporting proposals for presentation at the November 2011 meeting of the G20 in Paris.

On a parallel track and coordinated with the work of the IIRC, the Global Reporting Initiative (GRI) (www.globalreporting.org) Board of Directors in October 2010 approved a project for the fourth generation of the GRI Guidelines (G4) for delivery by the end of 2012. One key objective for G4 is to provide a foundation for companies preparing an integrated report based on the framework being developed by the IIRC.

Another potentially powerful initiative is being driven by the UN Principles for Responsible Investment (UN PRI) (www.unpri.org). One contributing catalyst for this initiative may be the June 2010 paper, *Integrated reports voluntary filing*, (http://www.world-exchanges.org/news-views/views/integrated-reports-voluntary-filing) by Robert Eccles and Mervyn King.[3] Eccles and King believe:

> "The role that stock exchanges can play will vary according to the laws of the country in which they are based, but in all cases they can make an enormous contribution in accelerating the rapid and broad adoption of integrated reporting by all entities to ensure a sustainable society. In some cases, the stock exchange will have the authority itself to design and implement such a program. In other cases, the exchange can encourage the appropriate regulatory body in its country, such as the securities regulator, to do so. In all cases, a voluntary filing program will require the collaboration of stock exchanges, regulatory bodies, companies, analysts, investors, and accountants as is being done by the IRC in South Africa. The stock exchange can also play the role of aggregator of these reports and organize working groups to study themes in order to generate insights for the IIRC that will be useful in developing a single global integrated reporting framework."

At the Sustainable Stock Exchanges (SSE) Global Dialogue in Xiamen in September 2010, Aviva Investors announced that the top 30 stock exchanges will be receiving a letter from investors that are signatories to the UN PRI applauding them for their sustainability efforts and inviting them to consider other ways of encouraging listed companies to report on ESG (environmental, social, and corporate governance) issues, including corporate integration of material sustainability information within financial reports, in other words, integrated reporting. The UN PRI and others are meeting with stock exchanges around the world to discuss how exchanges could encourage listed companies to adopt integrated reporting and the ways the business community can help stock exchanges do this. In addition, the UN PRI recently met with investors in London to discuss how investors could encourage companies to adopt integrated reporting.

The future of integrated reporting

History was made on October 14-15, 2010 when a diverse group representing analysts and investors; companies; technology and data vendors; accounting bodies; regulators and standard setters; NGOs; and civil society from around the world gathered at the Harvard Business School's 2010 Workshop on Integrated Reporting.

The workshop participants discussed the concept of integrated reporting, the role of reporting as a contributing factor to the creation of a more sustainable society, and the actions necessary to ensure the rapid and widespread adoption of integrated reporting.

The thinking of the participants has been captured in a free ebook, *The Landscape of Integrated Reporting: Reflections and Next Steps* (http://www.smashwords.com/books/view/30930). This collection of articles submitted by 64 workshop participants includes the thought-provoking opening remarks of Harvard Business School dean, Nitin Nohria. This ebook is to help broaden the awareness of integrated reporting, to help give it greater definition and clarity, and to help spread its rapid adoption around the world. Topics include the vision for integrated reporting; the role technology could play; and the myriad challenges to the broad adoption of integrated reporting.

Integrated reporting is a collective action problem, which simply means everyone with an interest in the quality of corporate reporting has a responsibility to act. My thoughts on a single action that analysts and investors; companies; regulators and standard setters; technology and data vendors; and stakeholders can take to bring us closer to making those visions for the future a reality follow.

These ideas were originally published in *The Landscape of Integrated Reporting: Reflections and Next Steps* and are reprinted with the permission of The President and Fellows of Harvard College, Cambridge, Massachusetts.

- Analysts and investors who believe that integrated financial and non-financial information – whether about strategy, plans, opportunities, and risks or environmental, social and corporate governance issues – is critical to their decision-making should tell regulators that integrated reporting is good for investors and markets. Analysts and investors must directly engage in a conversation with regulators. It is not enough to sign a letter or a petition proclaiming that the signatories represent X trillion dollars or Euros under management; institutional investors and pension funds, not just their membership organizations, need to look regulators in the eye and explain why integrated reporting matters.

- The CEOs of the 40 or 50 companies voluntarily issuing integrated reports should be much more vocal about why their companies have chosen to issue "one report." There is no stronger, more forceful advocate for integrated reporting than the CEO of a company actually doing it. CEOs should tell their employees, shareholders, customers, suppliers, regulators, and others about how the process of implementing integrated reporting has led to: (1) greater clarity about the relationship between financial and nonfinancial performance and the trade-offs that must be made when balancing financial and societal demands; (2) better informed decisions, which have improved the allocation of resources; (3) deeper engagement with all stakeholders resulting in a business strategy more attuned to society's ever changing needs; and, (4) two-way conversations that have helped to lower reputational risk, thereby increasing the likelihood of long-term corporate viability.
- Regulators should create an environment that encourages innovative companies to experiment with integrated reporting. Even though I firmly believe in the eventual need for mandates around integrated reporting, the inchoate state of reporting frameworks and assurance standards means that it is premature to call for regulation today. Integrated reporting "laboratories" similar to the U.S. Securities and Exchange Commission XBRL Voluntary Filing Program should be established by, for example, members of the International Organization of Securities Commissions. In a voluntary filing program, companies could furnish integrated reports and provide what they consider to be critical measures of financial and nonfinancial performance and explain how they are related. Investors, NGOs, and others could comment on these voluntary filings, thereby helping the reporting companies to improve their communications. This Wikipedia-like approach could also result in a more enlightened and participatory approach to regulation and standards setting.
- XBRL, which was highly touted in the vision statement created by this group at the HBS workshop, will not become a widely adopted reality unless technology and data vendors are willing to commit their financial and human resources to building taxonomies for the public good. Today's financial reporting when coupled with the potential volume of relevant nonfinancial information threatens to overwhelm the most sophisticated of analysts and investors. The promulgation of standards from the U.S. FASB, IASB,

IOSCO members, European Commission, Global Reporting Initiative, or the International Integrated Reporting Committee must be accompanied by a robust XBRL taxonomy. I don't see this happening without private commitments to build public taxonomies.

- Stakeholders, as it was said at the HBS workshop, must continue to ask tough questions. However, stakeholders need to understand that hard questions rarely result in simple black-and-white answers. Management will be making difficult choices that will result in one stakeholder group or another being disappointed, angry, or both. All stakeholders need to understand that an obvious and overwhelming "victory" by any single constituency is in fact a Pyrrhic victory. The value of "tough questions" is not necessarily reflected in the ultimate answer, but rather in the resulting understanding of how to balance the demands of the capital markets and the demands of the society on which business entities rely to create value.

Integrated reporting is a necessary step towards the long-term viability of—a business, the economy, our society, and the planet Earth. The stakes are high, so we have got to do this right!

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3. Governance: The Rules for Regaining Trust

3.1. Trust, where Trust is Due

by Christian Dreyer CFA

When my love swears that she is made of truth,
I do believe her though I know she lies,
That she might think me some untutored youth,
Unlearned in the world's false subtleties.
Thus vainly thinking that she thinks me young,
Although she knows my days are past the best,
Simply I credit her false-speaking tongue:
On both sides thus is simple truth suppressed:
But wherefore says she not she is unjust?
And wherefore say not I that I am old?
O! love's best habit is in seeming trust,
And age in love, loves not to have years told:
Therefore I lie with her, and she with me,
And in our faults by lies we flattered be.

Shakespeare, Sonnet 138

The crisis mantra has been – and continues to be – of restoring trust, of rekindling those animal spirits that are at the heart of the aggregate of human behaviour that is the economy. But perhaps the boom that we are now yearning to return back to by brute policy force already carried the seed of self-destruction? A long-term investor, we are acutely aware of the wild gyrations of mood swings, yet we advocate the policy makers keep their cool and stay away from trying, and inevitably failing, to micro-manage actors, whereas economic actors should regain modesty in the face of uncertainty. Capitalism is resilient, States are not.

What can I know?

The first question at the core of German philosopher Immanuel Kant's *Critique of Pure Reason* helps us to understand why trust is deemed important for economic cycles, but it also leads us to question the validity of trust as a driver for action.

Ever since Roosevelt's ominous 1933 *nothing to fear but fear itself*, the loss of trust is considered to be at the heart of economic crises. Yet, like pregnancy, trust is a binary variable only in individuals. In the marketplace, it lies at one end of a measurable continuum of outcomes of the cognitive process. What is, then, the opposite of trust?

In the real world of limited resources, limited knowledge and fundamental uncertainty about the future, making decisions based on trust is inevitable. In economic terms, relying on trust reduces transaction cost in an economy and thus encourages activity. But *what* activity?

Indeed, the buildup to the financial crisis may be read as a story of overabundance of trust, of overconfidence. When trust began to revert to its mean – as it always does, the house of cards collapsed. What follows is a brief summary of that narrative.

Ground zero of the crisis was the US real estate market. Everybody was confident that the only way this market could go was up. With that assumption firmly in place, everybody wanted a piece of the action, even if they could not afford it, and banks were happy to oblige, assuming that the rising tide would lift all boats. The subprime market was born.

The wealth effect was an important driver of consumption growth: Owners were able to draw cash from their real estate by increasing the mortgage to the higher value of their homes, hence the notion of the ATM at home. They trusted that rising prices would invariably help them build their home equity, given a year or two.

Next in line for leverage were banks. Thanks to confidence in the Great Moderation with its promise of permanently low interest rates and low volatility, they had no qualms to operate their balance sheets with very low equity ratios. Their confidence was boosted by a regulatory framework (Basel II) that relied on risk-weighting: Irish banks, for instance, were obliged to hold zero capital for Irish government debt. These low capital ratios generated outsize profitability. Profitability was enhanced even further by the securitisation of loan portfolios which were packaged and sold off under the *originate to distribute* model to other investors. Instrumental in that sale were top grade ratings equivalent to risk-free investments from rating agencies.

Rating agencies trusted their models, which promised very low probabilities of default even for portfolios of subprime loans, as long as the portfolio was diversified enough. This would be the objective presumption, without taking into account the conflict of interest built into the Rating agencies' business model by the fact that the issuer pays for its own rating.

Investors of course put faith in both Rating agencies and analysts, expecting that they could save on onerous due diligence for their investment activity by delegating the task to others. It is a known fact, though, that analysts tend to herd around the consensus opinion because the single biggest career risk for an analyst is to be wrong and alone. If the analyst is right and alone, then that's considered a lucky outlier, but if he's wrong in a crowd, then everybody else was equally wrong as well. That explains the reluctance of analysts to stray too far from the consensus mark and leads to group think.

When the edifice of trust started crumbling and threatened to take the banking systems of several countries down with it, nations took up the gauntlet and saved banks, even though many countries' balance sheets were already stretched with debt. This was deemed necessary as the fractional banking system itself is built on the notion of trust: banks go down if their liabilities are all called at the same time in a bank run. This is where Bagehot's[1] lender of last resort (the central bank) steps in. However, Bagehot would have groaned at the extent and indiscriminate nature of bank rescues performed recently: His precept only covers rescuing *illiquid* banks; *insolvent* ones should be left to default. But, obviously, default was not an option politically – hence the second part is often conveniently forgotten in the case of large institutions.

In the meantime, we have arrived at the stage where most of the excess financial sector leverage has been transferred to nations' balance sheets (private sector excess leverage has come down only marginally so far). Consequently, sovereign debt once deemed risk-free is now under scrutiny for default risk, and the first dominoes are already falling. The issuer of the world's reserve currency gets away with high debt levels at very low rates for now because investors still trust in the USD's status for lack of a better alternative. And default is still not an option politically.

The boom therefore rested on clay feet of abundant trust and overconfidence. Trying to rebuild it might be possible, but judging from the experience of increasingly severe past crises, the next one would be even worse. Should we really strive to go back there? Can we *sustainably* go back there?

Economic decisions are made in the realm of uncertainty. It is useful to gauge its extent by reference to a *taxonomy of uncertainty*.[2]
Complete *certainty* is only available

Taxonomy of Uncertainty

in the domain of classical physics and may therefore be disregarded in our context.

Most models of financial markets work with the definition of risk that is used at the second level of *risk without uncertainty*: all statistical properties of risk are fully known. This is the risk level appropriate to describe an honest casino.
Only now are we beginning to approach economic reality. Under *fully reducible uncertainty*, we assume that all possible outcomes are known, but not their statistical distribution. That can be estimated by empirical means, though. However, there needs to be a single, homogeneous model that causes the phenomena which we can observe in the world of fully reducible uncertainty.

Under *partially reducible uncertainty*, we are in a casino that may or may not be honest, and the rules tend to change from time to time without notice. This is where the monsters of reality live. Observed phenomena may well be generated and explained by multiple models. Sometimes, markets are liquid and efficient; sometimes they freeze up without warning. Analysis is valuable and has explanatory power, but only to the extent that it can reduce uncertainty.

The top two levels of uncertainty (*irreducible uncertainty* and *"Zen uncertainty"*) are characterized by model ignorance beyond the reach of any meaningful quantification. Therefore, they do not suit the requirements of practical life.

The taxonomy of uncertainty thus reveals two crucial facts:
- Risk and uncertainty are two altogether different animals, even though the terms are often used synonymously: Risk can be captured, described and forecast fully by statistical means, whereas un-

certainty cannot. In an uncertain reality, there always remains an unknowable likelihood of the unexpected.
- Many, if not most, economic decisions are made under conditions of uncertainty rather than merely risk. Weighted by impact, uncertainty decisions are almost certainly more important than risk decisions. The crisis has demonstrated beyond doubt the inability of risk-based models to cope with uncertainty issues. Effective practical consequences are yet to be drawn.

What ought I to do?

That brings us to the second question from Kant's Critique. Given that trust is not an unadulterated, stable good, and that economic decisions have to be made under uncertainty, what is a responsible course of action for political, regulatory and corporate leaders and investors?

Today's leaders know trust – they live and breathe it. That's why they responded forcefully to a perceived loss of trust in the system as the symptom of a liquidity crisis. But that response may well have been the wrong course from a systemic perspective. It assumed that the crisis was just a transient crisis of confidence (as in Bagehot's bank runs), whereas, in fact, it has become increasingly evident that we are dealing with a systemic solvency crisis.

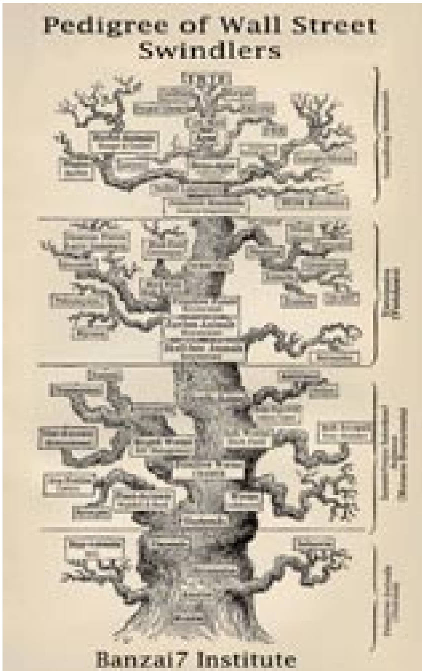
Leadership in a liquidity crisis is much less demanding than in a solvency crisis, because liquidity crises tend to be of shorter duration and often do not require painful measures. Usually they can be resolved by taking a swaggering stance on the part of the lender of last resort, deploying shock and awe and waiting until the crisis blows over. In a solvency crisis, however, painful & therefore unpopular cuts are inevitable. Deferred cuts are usually even more painful. It is in this context that Mervyn King, the Governor of the Bank of England, is quoted as having said that whoever wins the 2010 UK elections will be unelectable for a generation. Definitely not an encouraging outlook for the incoming team.

Many of the shock and awe measures taken during the crisis and in its wake proved to be of a hitherto unknown quality: Treasuries and central banks became directly involved in *negotiations* with threatened actors in order to find ways to stabilise them, rather than taking the traditional path of authoritative action. Negotiations by definition take place among equals, therefore, by choosing a negotiated approach, the authorities accepted to being placed at the same level as their counterparts.

Subsequently, governments took over or guaranteed liabilities from the financial sector without losses to holders of such liabilities, thereby taking the place of a regular actor in the financial markets with its own particular agenda, rather than the traditional role of the watchdog on one hand and the boringly conservative and predictable seller of government debt on the other (let's forget the tax authority for now). With rescue operations and – even more so – with unprecedented monetary and fiscal policy action, authorities entered the business of issuing promises they could not be sure they would be able to honour.

By doing so, authorities introduced systemic uncertainty at a level that was not built to handle it: the state. Citizens expect the state to be forever, whereas actors in the capitalist system may succeed *or* fail – they come and go. Failure is a necessary, indispensable part of the system. Capitalism has built in redundancy to cope with uncertainty whereas States do not. Their failure to honour a promise is a major event.

The modern state has evolved to reduce uncertainty for its citizens. In the terminology of uncertainty, its mechanism – the rule of law – is almost entirely located within the third layer of fully reducible uncertainty. The only gateway to uncertainty (apart from foreign policy) is the state of emergency and emergency law. It is hardly surprising, then, that



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much of the crisis rescue action had to be based on emergency law.

Authorities ought never to have left their relative comfort zone of *fully reducible uncertainty*. By entering the twilight zone of *partially irreducible uncertainty*, by making promises they could not be certain they can honour, they gave up their claim to permanence. Demanding trust is very well if you can be sure that it will be deserved by honouring the promises you make, but if it is obvious from the onset that you are wagering on an outcome that is beyond your control (*"Yes, we can"*), then the demand is foolhardy at best or disingenuous at worst. Electorates around the world intuitively comprehend that and are deeply dissatisfied.

What may I hope?

But such is the state of play. The authorities' choice of action has turned out to be relatively beneficial for now, and we must hope it remains that way in the interest of everybody. Nevertheless, the crisis is far from over. Indeed, the fundamental odds of an unfavourable outcome are mounting steadily:

- Government debt is unsustainably high and rising, even at low interest rates;
- deleveraging is a long-term process that will take years to bring private leverage down to its historic means, thereby reducing demand and potential growth;
- relatively feeble cyclical growth in mature markets is a result of unprecedented and unsustainable monetary and fiscal policy action;
- demographic dynamics of ageing populations are not helping;
- inflationary signals in the BRIC growth engines may put a break on their fast expansion;
- the political debate around austerity or fiscal stimulus is heating up everywhere.

Add to that mix an unstable currency union, managed currencies and potential regional armed conflicts. The resulting picture is complex and not very pretty. Hence, the answer to Kant's third question *What may I hope?* is "Not much."

In the scenario that is currently central, we will have kicked the can down another couple of years. Global growth resumes shakily, driven by the growth engines India and China, standing in for the deleveraging US. However, that scenario indeed carries the seed of self-destruction in an even bigger crisis because leaders will conclude that now, they *really* know how to manage the system. Overconfidence and trust will know no bounds – for a while.

The second scenario is less pretty in the near term, but more favorable longer term: Authorities take resolute steps to restructure their respective consolidated balance sheets as well as the financial services industry, putting a credible end to Too Big to Fail. This will likely cause some short-term market disruption, but it will put the nexus between the political domain and the financial industry at a healthy arm's length again.

The long-term investor always need to be prepared for all imaginable scenarios – and some unforeseeable ones, too. That means that our preference lies with a course of action which would (re)create a predictable and robust, or, in Nassim Taleb's word: anti-fragile environment as quickly as possible. To address the agency issues and conflicts of interest that are everywhere, this framework needs to encompass a high degree of transparency so that economic reality is faithfully represented in business reporting. One of the worst disservices to the cause of building trust in a trustworthy framework was perpetrated when accounting standard setters were forced to defuse some of their more powerful transparency provisions for the alleged benefit of stability. *But there can be no stability built on opacity.*

Until such time, prudent investors everywhere move to preserving wealth rather than growing it. That may well run counter to the interest and intentions of ill-advised authorities and leaders. But it is plausible in the face of some literature on crises and collapse such as Tainter[3] and Reinhart / Rogoff.[4]

Let me quote the Global Guerrillas Blogger John Robb:

> *"The need for evolutionary advances at the local level will always outstrip the pace of evolutionary change at the center. When the mismatch grows too large, the entire system collapses."*[5]

Some think that the crisis has dealt capitalism a fatal blow from which it will never recover. I beg to differ: Capitalism as a mode of resource allocation is extremely resilient and will survive the collapse of a host society that has become too complex. Let us hope against hope, therefore, that rather than make them more complex, we will be able to reduce the complexity of our governance structures in order to make them more robust. That way, we might be able to trust in Trust again.

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3.2. Microfinance Investment Funds – Analysis of Portfolio Impact before and after the Financial Crisis

by Henry Schäfer and Oliver C. Oehri

Introduction

Microfinance has become a globally heeded theme since the UN declared 2005 the International Year of Microcredit, and in 2006 Muhammad Yunus was awarded the Nobel Peace Prize. The origins of microfinance lie in, among other things, a philanthropic movement whose aim was to provide credit aid to economically active people in poverty. Microfinance can be an effective instrument for fighting poverty. Over the years, the start volume has grown very rapidly and produced a new market segment which has allowed micro-enterprises official access to financial services. In accordance with this rapid growth and the transformation of the microfinance sector, the market, and especially the participants, have become subject to significant structural changes. At a very basic level, microfinance can be understood as the availability of financial services (loans, saving models, capital transfers and insurance) to micro-entrepreneurs and households with low incomes that would otherwise have no possibility of using the services of local credit institutions. Microfinance thus provides affected population segments primarily in developing and emerging market countries with access to financial products. A business loan ranging from USD 50 to 5,000, a so-called microloan (a.k.a. microlending), is the most common form made available by this type of financial service (Felder-Kuzu, 2005). The extension of microloans to microentrepreneurs in developing and emerging market countries is conducted by microfinance institutions (MFIs), which specialise in this type of credit extension and are locally based (Oehri et al, 2010).

In practice, the aforementioned basic idea has solid references in the area of developmental help and assistance. Approximately 2.7 billion people are affected by poverty and live on less than USD 2 per day (World Bank, 2007). Of these, many people can be considered as economically active as they try to increase their income and improve their living situation. Hence, they also have a need for small business loans and other financial services in order to become economically independent. According to current estimates, however, a great majority of these microentrepreneurs are still dependent on borrowing from informal moneylenders at horrendous interest rates. Based on the assumption that 500 million small businesses each year require an average loan of approximately

USD 500, the annual demand for microloans stands at USD 250bn (Dieckmann, 2008). According to expert opinions, only a portion of today's credit needs are presently being met. The national credit markets of developing countries cannot at present meet the required credit volume alone, therefore sustainable access to international capital markets and foreign (investment) capital is a crucial component (Oehri et al, 2010).

The topic of microfinance as a financial investment has particularly experienced a boom in recent years. They are finding increasing interest from institutional investors as well as private investors. At the end of 2008, over 100 so-called Microfinance Investment Vehicles (MIVs) were identified worldwide with an investment volume of a good USD 6.6 billion. The Microfinance Investment Funds (MFIFs) represented just a small part of the MIVs. In general, MIVs are directly invested in MFIFs. These investments can be made in the form of equity or debt capital. Studies of the investment capital structure of MIVs have revealed, that debt capital (fixed income investments) is still preferred and 75% of the microfinance investment volume is being effected from this form (Reille et al, 2009).

Due to the novelty of MFIFs, the annual return and risk characteristics as well as the benefits in a diversified portfolio are not sufficiently known (Oehri and Fausch, 2008).

This study analyses the risk-return profiles of selected MFIFs and the impact of MFIFs on standard-structured portfolios. The research is set out as follows: In Part 2, we give a short overview of the applied methodology. Relevant criteria for our fund selection are described in Part 3. In Part 4, we analyse the risk-return profile of the selected MFIFs and their benefits and risks in standard-structured portfolio. Part 5 contains the impact of the financial crisis and Part 6 is the conclusion of the paper.

Methodology

In order to quantify the portfolio theoretical influence of the selected MFIFs the following framework has been chosen:

1. First we build a sample portfolio consisting of stocks, bonds, hedge funds and a money market. The sample portfolio consists of a global stock index (MSCI World), a global bond index (JPM GBI – Government Bonds Index), a hedge funds index (Hedge Funds Research Index HFRI), and a money market fund (UBS Money Market Fund). The risk-free investment opportunity is represented by the 6-month LIBOR.
2. Furthermore, we define three investment strategies dependent on the investors various risk attitudes, as shown in Table 1.

Table 1: Sample Portfolios – Three Investment Strategies

	Asset Classes				
Investment strategy	MFIF	Stocks	Bonds	Hedge Funds	Money Market
Growth	0%	60%	10%	25%	5%
Balanced	0%	40%	30%	20%	10%
Defensive	0%	20%	50%	20%	10%

3. Finally we modify the portfolios – "defensive." "balanced" and "growth" with MFIFs.

In this context, we analyze the effects of 5% and 10% MFIFs substitution for these three investment strategies (defensive, balanced and growth) as well as the impact of the recent financial crisis. A total of 24 portfolios were created, whereas 5% and 10% of the given asset classes are substituted by MFIFs.

The expected portfolio return (μp) and the portfolio risk (σp) are determined on the basis of the following formula (Markowitz, 1952).

$$\mu_p=\sum_{i=1}^{n} x_i \mu_i \quad (1) \qquad \sigma_p^2=\sum_{i=1}^{n}\sum_{j=1}^{n} x_i x_j \, ov_{ij} \quad (2) \qquad \sigma_p=\sqrt{\sigma_p^2} \quad (3)$$

The Sharpe Ratio is given as the quotient of the realised excess return and the portfolio risk.

$$SR_p=\frac{r_p-r_f}{\sigma_p} \qquad (4)$$

Research sample – five restrictions have been introduced to select MFIFs:

1. Microfinance investment quote: at least 70%
2. Capital structure: Debt >50% (microfinance fixed income mutual funds)
3. Time series: at least 5 years
4. Money market adequate return (LIBOR plus)
5. Price setting / Net Asset Value (NAV) evaluation: monthly

Based on the MFIF opportunity set, the following two MFIFs and the SMX as an industry benchmark were chosen:

Table 2: Overview of Selected MFIFs

	Dexia Micro-Credit Fund (Dexia)	responsAbility Global Microfinance Fund (responsAbility)	SMX USD – Symbiotics Microfinance Index (SMX)
Fund currency	US Dollar	US Dollar	US Dollar
Inception	September 1998	November 2003	December 2003
Observation period	11 years	6 years	6 years

Empirical results

The following distribution parameters are given for the observation period:

Table 3: Overview of Distribution Parameters, Monthly End-date, Risk-free Rate: LIBOR 6 Months USD, Own Calculations, Data Sources: Datastream, responsAbility, Symbiotics

	Period	Return	Risk	Min.	Max.	LIBOR	Sharpe Ratio
Dexia	01.99-12.09	4.71%	1.01%	-0.72%	1.22%	3.53%	1.1651
responsAbility	01.04-12.09	4.19%	1.23%	-0.33%	2.54%	3.35 %	0.6853
SMX	02.04-12.09	4.51%	0.53%	0.06%	0.99%	3.38%	2.1399

The observation period reaches from 31.12.1998 to 31.12.2009 and includes different market phases: the bear market from 1999 to 2002, the bull market from 2003 to 2006 as well as the financial market crisis starting in July 2007.

Table 4: Overview of Distribution Parameters, Monthly End-date, Risk-free Rate: LIBOR 6 Months USD, Own Calculations, Data Sources: Datastream, responsAbility, Symbiotics

	Period	Return	Risk	Min.	Max.	LIBOR	Sharpe Ratio
MSCI World	01.99-12.09	1.57	15.59	-17.84	9.92	3.53	NA
	01.04-12.09	3.66	15.16	-17.84	9.92	3.35	0.0206
JPM GBI	01.99- 12.09	5.43	7.31	-5.12	6.82	3.53	0.2596
	01.04 – 12.09	5.35	7.40	-5.12	6.82	3.35	0.2712
HFRI	01.99-12.09	5.88	6.06	-6.54	6.85	3.53	0.3887
	01.04-12.09	3.60	6.30	-6.54	3.32	3.35	0.0399
UBS MM	01.99-12.09	2.86	0.55	0.01	0.57	3.53	NA
	01.04-12.09	2.49	0.48	0.01	0.44	3.35	NA

Diagram 1: Overview of the Observation Periods (Market Phases)

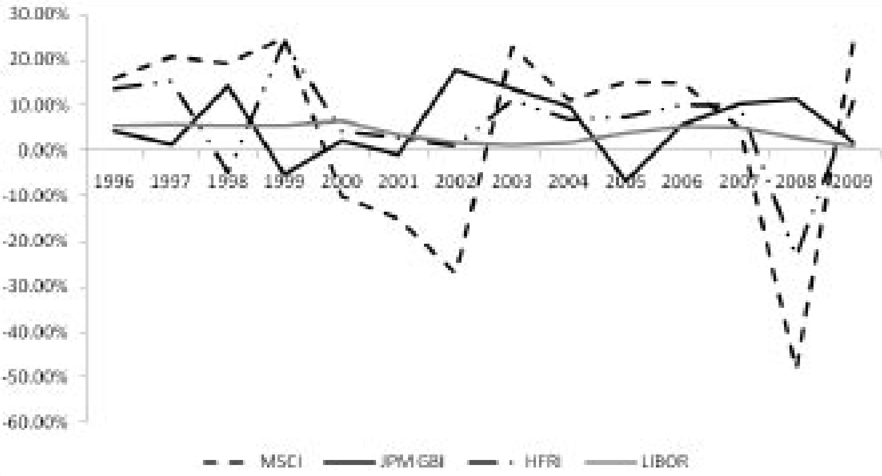


Table 5: Dexia Micro-Credit Fund Correlation Matrix (January 1999 - December 2009)

	Dexia	MSCI	JPM GBI	HFRI	Money Market
Dexia	**1.00**				
MSCI	-0.09	**1.00**			
JPM GBI	0.04	-0.08	**1.00**		
HFRI	-0.15	0.65	0.00	**1.00**	
Money Market	0.31	-0.02	-0.11	0.11	**1.00**

Dexia

As can be seen in Table 5, the Dexia MFIF shows a low correlation to all considered asset classes. The Dexia MFIF correlates to the bond index slightly positive (+0.04), and has a negative correlation to the stock and hedge funds index (-0.09 and -0.15 respectively).

If the Dexia MFIF is taken as a substitute for the given asset classes, in two of four substitutions the risk-adjusted excess return (Sharpe Ratio) improves. If the Dexia MFIF is chosen to substitute stock investments the best risk-adjusted return of the portfolios can be achieved. Compared to stock investments the Dexia MFIF

Table 6: Sharpe Ratios (01.1999 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (Dexia substitution with given asset class)							
Investment strategy		**Stocks**		**Bonds**		**Hedge Funds**		**Money Market**	
Growth	NA	NA	NA	NA	NA	NA	NA	NA	*
Balanced	0.03	0.05	0.09	0.02	0.02	0.02	0.01	0.04	0.05
Defensive	0.18	0.24	0.30	0.18	0.19	0.18	0.17	0.20	0.22
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

* indicates that the growth portfolio only consists of 5% money market, and therefore, no 10% substitution is possible for the money market.

Table 7: Standard Deviations in % (01.1999 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (Dexia substitution with given asset class)							
Investment strategy		Stocks		Bonds		Hedge Funds		Money Market	
Growth	10.38	9.60	8.82	10.38	10.39	10.15	9.93	10.37	*
Balanced	7.27	6.53	5.81	7.19	7.12	7.05	6.83	7.26	7.26
Defensive	5.26	4.75	4.32	5.02	4.80	5.07	4.89	5.26	5.25
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

generates constant positive returns during all market phases. Therefore the risk-adjusted excess return for portfolios can be smoothed, especially during unfavourable market developments. Compared with the sample portfolio, a decline in the Sharpe Ratio is proven if Dexia MFIF is taken as

Diagram 2: Overview of the Observation Periods Including Returns from Dexia

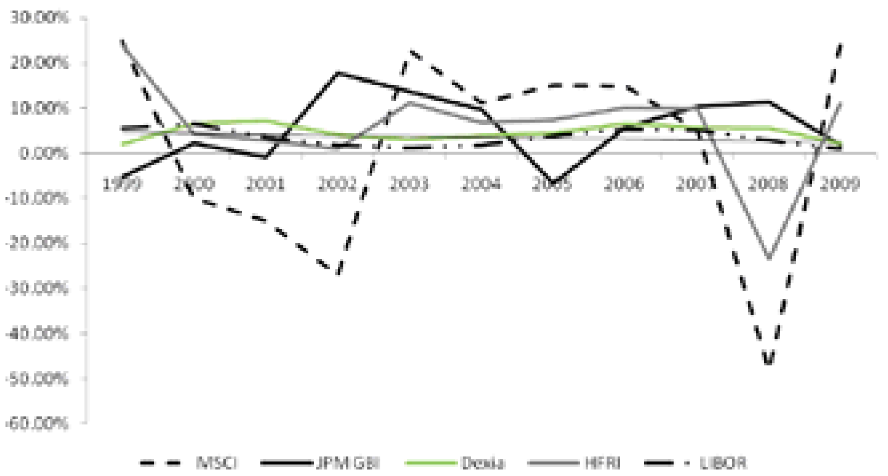


Table 8: Returns in % (01.1999 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (Dexia substitution with given asset class)							
Investment strategy		**Stocks**		**Bonds**		**Hedge Funds**		**Money Market**	
Growth	3.10	3.26	3.41	3.06	3.03	3.04	2.98	3.19	*
Balanced	3.72	3.88	4.03	3.68	3.65	3.66	3.60	3.81	3.90
Defensive	4.49	4.65	4.80	4.45	4.42	4.43	4.37	4.58	4.67
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

a substitute for the hedge fund and the bond index. We argue that the Dexia MFIF, the hedge funds and the bond index have low correlation to most asset classes as well as to each other. Therefore beneficial portfolio characteristics (low correlation, high Sharpe Ratio) of both asset classes are only replaced by each other. This results in a loss of diversification as well as performance within the portfolio and subsequently to a lower Sharpe Ratio.

When looking at the portfolio risk (see Table 7), it can be seen that the Dexia MFIF leads to a reduction of portfolio risk, with exception of the 10% bond substitution with Dexia MFIF for the growth portfolio (10.39). In this case it leads to an increase in standard deviation. We argue that the bond index has a lower correlation to the stock index compared to the MFIF. Therefore the bond investment generates smoother returns in a portfolio compared to its substitute, the Dexia MFIF, especially during unfavourable market phases.
In general, the standard deviation is reduced through a 5% substitution with Dexia MFIF on average by about 0.25%, and through a 10% substitution even by about 0.49%. The results show that the MFIF offers an important risk reduction benefit within the portfolios analysed, due to reduced risk and lower correlation to traditional asset classes.

The Dexia MFIF increases expected portfolio returns for all portfolio strategies when it is used as a substitute for stock and money market investments. Regarding bond- and hedge funds investments the opposite is demonstrated, since the expected returns are lower for all

Table 9: responsAbility Correlation Matrix (January 2004 - December 2009)

	respons-Ability	MSCI	JPM GBI	HFRI	Money Market
responsAbility	**1.00**				
MSCI	-0.29	**1.00**			
JPM GBI	0.05	0.04	**1.00**		
HFRI	-0.17	0.75	0.00	**1.00**	
Money Market	0.42	-0.02	0.03	0.09	**1.00**

portfolio strategies. This result is not so surprising because the expected returns of the stock index and the money market fund are lower during the observation period than those of the Dexia MFIF. On the other hand, the expected returns of the bond and hedge funds index are higher than those of the Dexia MFIF. This means that in this context the Dexia MFIF substitution into bond or hedge fund investments has an adverse effect on portfolio returns.

responsAbility

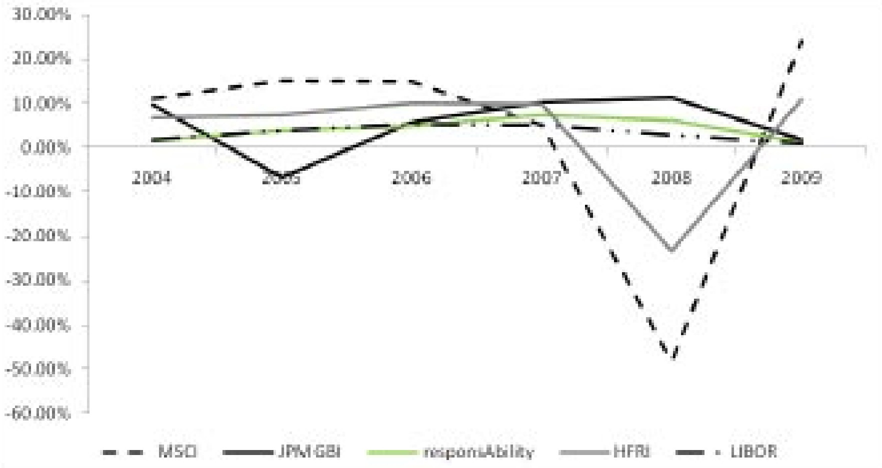
The same procedure used to analyse Dexia is now carried out on the second MFIF (responsAbility). The observation period was six years from 2004 to 2009.

The benefits of responsAbility MFIF in a portfolio depends on the asset class to be substituted as well as the chosen investment strategy. A substitution leads to improvements in the Sharpe Ratio for all asset classes and

Table 10: Sharpe Ratios (01.2004 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (responsAbility substitution with given asset class)							
Investment strategy		**Stocks**		**Bonds**		**Hedge Funds**		**Money Market**	
Growth	0.04	0.05	0.05	0.03	0.03	0.04	0.05	0.05	*
Balanced	0.09	0.11	0.12	0.09	0.08	0.10	0.11	0.10	0.12
Defensive	0.18	0.21	0.24	0.18	0.18	0.20	0.21	0.20	0.22
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

Diagram 3: Overview of the Observation Periods Including Returns from responsAbility



investment strategies expected for the bond index.

A responsAbility MFIF substitution demonstrates a risk reduction in all asset classes. Except in the case of a money market substitution the investment strategy Defensive leads to higher risk.

Table 11: Standard Deviations in % (01.2004 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (responsAbility substitution with given asset class)							
Investment strategy		**Stocks**		**Bonds**		**Hedge Funds**		**Money Market**	
Growth	10.38	9.61	8.83	10.33	10.29	10.11	9.83	10.36	*
Balanced	7.47	6.73	6.01	7.33	7.22	7.21	6.95	7.45	7.43
Defensive	5.58	5.03	4.54	5.31	5.06	5.36	5.16	5.65	5.54
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

Table 12: Returns in % (01.2004 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (responsAbility substitution with given asset class)							
Investment strategy		Stocks		Bonds		Hedge Funds		Money Market	
Growth	3.76	3.78	3.81	3.70	3.64	3.78	3.81	3.84	*
Balanced	4.04	4.07	4.09	3.98	3.92	4.07	4.10	4.12	4.21
Defensive	4.38	4.40	4.43	4.32	4.26	4.41	4.44	4.46	4.55
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

In terms of portfolio returns the responsAbility MFIF substitution has a positive impact on the return for all investment strategies, except it is used as substitution for bond investments. The analysis shows that MFIF substitution is favourable in terms of a risk/return relationship in all investment categories with exception of the bond index.

SMX

The same procedure used to analyse Dexia and responsAbility is now carried out on the SMX as an industry benchmark. Not surprisingly, the results for the SMX are similar to the substitutions analysed above.

The conducted analysis shows that the benefits of a MFIF substitution

Table 13: Sharpe Ratios (01.2004 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (SMX substitution with given asset class)							
Investment strategy		Stocks		Bonds		Hedge Funds		Money Market	
Growth	0.02	0.02	0.03	0.01	0.01	0.02	0.02	0.03	*
Balanced	0.07	0.01	0.11	0.07	0.06	0.08	0.06	0.08	0.03
Defensive	0.16	0.19	0.22	0.16	0.16	0.18	0.15	0.18	0.04
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

Table 14: Standard Deviations in % (01.2004 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (SMX substitution with given asset class)							
Investment strategy		Stocks		Bonds		Hedge Funds		Money Market	
Growth	10.44	9.68	8.91	10.40	10.37	10.18	9.92	10.43	*
Balanced	7.52	6.79	6.07	7.39	7.28	7.02	7.51	7.45	7.50
Defensive	5.62	5.07	4.59	5.36	5.11	5.41	5.22	5.61	5.60
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

depends mainly on the market situation. The impact of the financial crises on portfolios with MFIF substitution is analysed in the next part.

Impact of the financial crisis

Demonstrating the impact of microfinance substitution in challenging market times provides suitable examples. In order to analyze the consequences of the recent market turmoil, we must compare the sample portfolios before and after the financial market crisis. For that purpose Dexia is used as representative of the MFIFs due to the longest available data sample of all mutual funds. Therefore we analyszd and compared Panel A (before the crisis: 31.12.1998 – 30.06.2007) and Panel B (after the crisis: 01.07.2007 – 31.12.2009). We took Dexia as representative of the MFIFs.

Table 15: Returns in % (01.2004 - 12.2009, Own Calculations)

	Sample portfolio	new portfolios (SMX substitution with given asset class)							
Investment strategy		Stocks		Bonds		Hedge Funds		Money Market	
Growth	3.56	3.62	3.67	3.52	3.48	3.62	3.68	3.66	*
Balanced	3.91	3.96	4.02	3.87	3.82	3.97	4.02	4.01	4.11
Defensive	4.30	4.35	4.41	4.26	4.21	4.36	4.41	4.40	4.50
% MFIF substitution	0%	5%	10%	5%	10%	5%	10%	5%	10%

Findings for the different MFIFs are close to each other, but Dexia has the longest duration (11 years).

The analysis across all asset classes and investment strategies shows an increase in the average Sharpe Ratio. As expected, lower returns and higher risk can be observed during the crisis.

The financial crisis had its strongest impact on stocks and hedge funds. Before the crisis, stocks and hedge funds offered higher returns than the Dexia MFIF. However, this relationship changed in July 2007. The correlation between Dexia and the stock market, as well as Dexia and the hedge funds index, decreased substantially to -0.35 respectively -0.34. Consequently, a MFIF substitution of stock and hedge funds has a positive impact on the Sharpe Ratio and therefore also on portfolio performance, especially in uncertain times such as the financial crisis.

The opposite can be observed for the bond substitution which results in a negative Sharpe Ratio. This is due to a change in correlation between MFIF and the bond index from 0.00 to 0.18 (relating to the similar characteristics of both asset classes). The higher correlation implies a shift in investor behaviour from risky portfolios to less risky portfolios in those times.

For the chosen observation period, the overall analysis shows that the MFIFs provide a stable risk/return relationship regardless the market cycle. Therefore, portfolio substitution with MFIFs can be a meaningful tool of portfolio diversification.

Conclusions

Summing up, it can be stated that all the analysed MFIFs show low volatility, low correlation to the analyzed asset classes as well as stable returns

Table 16: Dexia Micro-Credit Fund Correlation Matrix (July 2007 - December 2009)

	Dexia	MSCI	JPM GBI	HFRI	Money Market
Dexia	**1.00**				
MSCI	-0.35	**1.00**			
JPM GBI	0.18	-0.08	**1.00**		
HFRI	-0.34	0.65	0.00	**1.00**	
Money Market	0.58	-0.02	-0.11	0.11	**1.00**

for the chosen observation period. The study results suggest that MFIFs can be a meaningful tool for portfolio diversification. The findings are dependent on the observation period, since the correlations between the individual investment categories vary with time and cannot be regarded as fixed. However, it has to be stated that the most important factor of substitution with MFIFs is the quality of the underlying microfinance portfolio. So if the portfolio at risk of the MFIFs changes, the above mentioned benefits of the substitution may change adversely. Furthermore, it is important to note that there is no secondary market for microfinance and therefore no continuous pricing according to supply and demand.

Over the last years, the start volume grew very rapidly and produced a new market segment which allowed micro-enterprises official access to financial services. In accordance with this rapid growth and the transformation of the microfinance sector, the market, and especially the participants, have become subject to significant structural changes. Today, the microfinance sector is confronted with new challenges as well as new opportunities. An important step in improving this situation lies in developing new or additional financial sources with affordable conditions through innovative financing mechanisms, technologies and business models. An opportunity could be the combination of microfinance and climate protection. One way of combining consists of the assumption that granting microcredit loans covers part of the financing for decentralised and renewable energy technology (microenergy credits), in order to enable the use of more efficient cooking facilities, solar cookers or small biogas systems. There is a challenge as well as a danger that these micro(energy) loans do not lead directly to the generation of income. In this respect, it could help if emission credits were generated from projects of the Clean Development Mechanism (CDM). Companies from industrial countries could invest in projects that bring about reductions in emissions, and issue credits for these. The companies could then use these credits to cover their own emissions, as required, for instance, in European emissions trading. However, the procedure is complex and involves a cost-intensive approval procedure. At present, there is not yet a clear answer to the question of whether it is feasible to link microcredit loans and emission credits.

This paper is primarily research on the portfolio impact of microfinance investment funds. The results of this study cannot be considered as terminal and deliver a first insight into the portfolio theoretical consequences of

MFIFs. We have therefore to address further research to verify the results as well as to consider other aspects.

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3.3. Responding to Current Challenges: The Economics of Shared Societies

by The Club de Madrid[1]

We, the Members of the Club de Madrid , are concerned with issues such as climate change, social divisions and intergroup hostility, and of course the problems resulting from the financial crisis. We are now able to go behind the immediate problems and examine the underlying dynamics which have made these problems so intractable. From our time in office and our political experience before and after, we are aware of the interdependent world and the importance of reaching common approaches to problems which we all share but we are also aware that it is inordinately difficult to achieve such common positions. There is a tendency to consider the short term interest of one´s country, or more correctly, one´s government. And leaders have to respond to the pressures from political and economic interests that look for special privileges and special protection.

It is also an interdependent world as capital is now not rooted in specific states but is free to move where it will be to its advantage. So global business has outstripped the capacity of individual states to regulate and international organizations have not developed to take on that responsibility.

The Club de Madrid (www.clubmadrid.org), made up of over 70 former heads of state and heads of government takes a keen interest in the challenges which the global community faces. Being now out of office, its members are not faced with dealing with the day to day demands that come to current leaders and are able to take a longer term view of the current situation. Their status as former leaders mean that they are then well placed to bring those issues to the attention of current leaders and work with them to develop ways of responding. They aim to bring new perspectives to these problems.

But there is another sense in which we are very aware of the interdependency of the world, in that the issues we face are interdependent. As we work on responding to climate change, building sustainability and promoting what we call shared societies to combat social divisions, we realize that they are intimately bound up with the financial crisis that we are struggling with.

This interdependence works in both directions. Resolving the financial crisis is necessary to respond effectively to the other challenges we face. But equally appropriate responses to the other issues opens up ways to respond to the financial challenge.

In particular, the Shared Societies Project of the Club de Madrid has been examining how economic well-being is linked to progress on achieving a shared society. Our members have adopted the following statement which succinctly explains and advocates our develops the economic rationale for shared societies.

The Club de Madrid Statement on the Economics of Shared Societies

We, the Members of the Club de Madrid, are committed to the development of Shared Societies, where people hold an equal capacity to participate in and benefit from economic, political and social opportunities regardless of race, ethnicity, religion, language, gender or other attributes and where, as a consequence, relations between groups are peaceful.

We are convinced that this is not only inherently desirable but also economically beneficial. We bring this message to current national leaders and their countries but also to global financial and political institutions which too often overlook this fact and focus on fiscal rectitude, which is important, to the detriment of the social and human dimensions of social development and economic growth, which are equally important.

Shared societies enjoy better prospects for economic well-being, which we understand to be sustained economic growth with equity, and gains for all. You cannot have sustained and equitable economic well-being where you do not have inclusion. Shared societies generate economic dividends for governments, businesses, communities, families, and individuals. Through a virtuous cycle, these economic dividends of shared society further enhance a society's capacity to be shared, which in turn generates more economic dividends.

To explore these links further, the Club de Madrid established an Expert Working Group which reported to the Members and has confirmed and elaborated on our analysis of this virtuous cycle connecting economic wellbeing and shared societies.

How does the virtuous cycle work?

1. Governments that engage and invest in all members of its society –- through such means as equitable distribution of resources, education, health care, and infrastructure -- foster a productive and dynamic environment to maximize the economic contributions of all individuals, regardless of their race, ethnicity, religion, language, gender or other attributes.

2. Such governments are responsive to all the people's needs, and remain

in contact with their populations' priorities. This responsiveness leads to societies composed of populations that identify with and support the common good. When government engages and invests in its people, they are more likely to have a sense of belonging and to be more willing to support the state, enhancing stability.

3. Therefore business enterprises in shared societies can draw on a stable, more educated, diverse and productive population and access the skills and creativity offered by all individuals. Entrepreneurship, creativity and innovation flourish in a peaceful, tolerant and stable environment and it becomes attractive to inward investment. The overall economic wellbeing of a country or community is enhanced.

4. An added benefit of this social contract between government, the business community and all sections of the public is increased transparency of the political institutions and an increased understanding of public spending. This contributes to reduced corruption and less wasteful public spending. Taken together, a shared society enhances the fiscal dividend to the state, enhancing its economic wellbeing and provides the resources to farther promote a shared society.

5. When the broader economy flourishes so too do individual households. Households, that are included within broader society and benefit from the economic dividend of a more stable society, tend to be stronger and more resilient in the face of misfortune. The economic contribution of all individuals becomes a critical factor in a country's ability to overcome external shocks to its economy.

This virtuous cycle is also enhanced by the reductions in costs that result from a shared society and the release of resources previously set aside to maintain the status quo, including policing and security measures to manage intercommunity tensions.

Shared societies make economic and social sense.

What can we do?

We urge all leaders and global financial institutions to recognise that Shared Societies benefit everyone and to take all steps to bring them about. Any other policy is short sighted. We also call on them to adopt the Call to Action of the Club de Madrid. We commend to them the existing Ten Commitments for Shared Societies of the Club de Madrid which indicate how a shared society can be achieved.

We invite the wider community to support leaders working to build shared societies, realizing that they too will ultimately benefit, and encourage them to bring the economic argument for building shared societies to leaders who are not at present responding to it.

The Expert Working Group that the Club established has identified Ten Guiding Principles that should guide national and international policymakers in their discussions and formulations of all policies related to fiscal, social, and economic development policy. The Members of the Club of Madrid endorse and adopt these Guiding Principles in its work both in peer to peer consultation in specific countries, in its involvement with International Bodies such as the United Nations, World Bank and regional intergovernmental bodies and in its participation in public debate and discussion generally.

We call on current leaders and international institutions to adopt these Guiding Principles as a framework for their own policies and programmes.

We seek a fairer and more inclusive international order to provide the global environment in which individual countries are encouraged to build their own Shared Society.

We and the Expert Working Group have made a series of specific recommendations which we commend to current leaders for serious consideration and implementation.

The Guiding Principles and recommendations mentioned in the statement are:

Recommendations on Policy, Practice and Structural Initiatives

The following recommendations of the Club de Madrid, mainly related to economic policy, are partly based on the report of the Working Group but are also the result of the Club de Madrid's own deliberations. Most of them are practical applications of the Guiding Principles and that link is made explicit in the way they are laid out.

Guiding Principle 1

Shared societies, in which diverse groups and individuals are economically integrated and utilise their talents and skills, tend to be more stable societies which enjoy higher economic growth than divided societies

Guiding Principle 2

If groups and individuals are economically marginalized they have no reason to feel a sense of belonging to the state and are less likely to support the state or society and contribute to the economic wellbeing of all.

Therefore:

- In setting national goals and policy frameworks, governments and international institutions need to consider fairness and equality as important factors alongside financial rectitude and support for the business sector

- A key priority for public spending should be those sectors which uplift marginal groups and facilitate their participation in the economy as productive members of society – sectors including education, public health, infrastructure development in marginal areas and support for entrepreneurial activities within marginalised communities

Guiding Principle 3
The cost of investing in a shared society and ensuring that marginalised groups feel they have a full place in society is more than compensated for by the contributions those people can then make.

Guiding Principle 4
Leaving groups and individuals on the margins of society is not cost free, as it creates social, political and security problems which are avoidable, unnecessary and costly.

Therefore:

- Governments and international institutions need to raise awareness of the benefits of progressive tax systems that correct gross income inequalities and benefit more disadvantaged groups in order to gain public support for such systems.
- Governments need to involve the public more in decisions on public expenditure decisions in order to achieve their support for those policies and to ensure the policies meet the needs of the wider population. This requires greater transparency about economic issues, greater participation and in general greater public influence on public expenditure.

Guiding Principle 5
National and local economic policies and programmes play a major role in creating an inclusive dynamic for all groups.

Guiding Principle 6
National and local economic policies and programmes too often mainly benefit those who are already successful and influential, and as a result reinforce social divisions.

Therefore:

- Taxation policies should be assessed in terms of their impact on the achievement of a shared society and their reduction of inequality between groups.
- More creative mechanisms are needed for the delivery of social spending, with, particularly in countries facing the challenge of a

growing youth population, emphasis on education and training.
- Governments need to promote greater awareness among the informal and underground economies of the benefits of joining and supporting the formal economy as a means to broaden the tax base.

- Those countries that have insufficient or deficient systems of social protection need to reform them to establish basic universal coverage as they support the development of a shared society and external assistance should be provided for low income countries that do not have sufficient resources.

Guiding Principle 7

The international economic frameworks and institutions that support them need to be reformed to ensure a fair, equitable and sustainable international economic order and business practices, and encourage appropriate national policies leading to shared societies and greater economic wellbeing throughout.

Therefore:
- Because national governments are often powerless in the face of global economic forces including global business corporations and economically powerful states, urgent action is required to reform the global financial institutions to ensure they are responsive to the needs of more disadvantaged countries and more disadvantaged communities.
- A key requirement for a more effective and fairer international governance is greater complementarity and coordination between the various IGOs which deal with economic and financial issues.
- A second key requirement is that inter-governmental institutions become more democratic by allowing smaller and poorer states to have more influence and decision making power alongside wealthy and economically powerful states. This should lead to more effective policies because they take into account the needs of all nations. At present international financial institutions are heavily weighted in favour of richer and more powerful states

Guiding Principle 8

Existing international economic frameworks need to ensure that wealthier countries and vested interests do not benefit at the expense of poorer states and marginalised groups within all states.

Therefore:
- International agreement is required on tax avoidance and tax haven which allow the more mobile, who are often the more wealthy members of society and business organisations, to avoid playing their full part in supporting government finances.

- International consensus on the taxation of global business organisations is necessary to ensure that they pay taxes in the countries where profits are made.
- In order to increase economic opportunities for the population of low income countries, high income countries should create fair trading conditions, including the opening of markets and the phasing out of subsidies to agriculture, which distort trade and impose heavy costs on the developing world. High income countries have to create greater awareness with their population of the unfair nature of subsidies and protectionism, including those who benefit from them.
- It would be desirable to create a global fund to support countries building a shared society, creating opportunities for those previously excluded and providing them with social protection. The UN Social Protection Floor Initiative could provide the framework for such a fund.
- Governments and international fiscal bodies should explore innovative ways to raise funds (e.g., international tax on financial transactions, carbon taxes) to address the divisive social and economic implications of climate change, which are expected to be especially harsh on the developing world and disadvantaged groups, and ensure progress towards shared societies.

Guiding Principle 9
Well intentioned economic policies often fail to benefit marginalised sections and integrate them into society because of unintended consequences. They can be subverted by influential sectional interests.

Therefore:
- Governments should establish systems of monitoring and auditing public policies to ensure that they do not disadvantage already marginalised groups and, instead, that they help to involve them in the wider society.
- International institutions should take steps to assist states to monitor how far their actual or proposed policies will increase of decrease marginalisation of sections of the population. For example, the Article IV Consultation process of the IMF could broaden the content of policy discussions with its members to include aspects of social cohesion and shared societies.
- However, such actions are only appropriate if these bodies are more accountable to the wider membership.

Guiding Principle 10
Economic policies are more likely to benefit those who are marginalised and integrate them into a shared society if marginalized groups are involved in the planning and implementation of policies and pro-

grammes and if there is a mechanism to screen policies and programmes for their differential impact on each section of society.

Therefore

- Mechanisms should be put in place that ensure marginalised sections of society are consulted and involved in economic and other policies which affect their interests. This may include a statutory right to consultation
- Self-help initiatives should be introduced and supported, as they ensure that people can participate and influence their own affairs

Academic research

The academic community should be encouraged and supported in carrying out studies to confirm and explain the link between shared societies and economic wellbeing and in particular it is suggested that a Shared Societies Index offers a potentially powerful tool.

1 The Club de Madrid (www.clubmadrid.org) is a non-partisan organization made up of over 75 former heads of state and heads of government from over 55 countries. Its membership takes a keen interest in the challenges which the global community faces. Being now out of office, Club de Madrid Members are not faced with dealing with the day to day demands that come to current leaders and are able to take a longer term view of the current situation. Their status as former leaders mean that they are then well placed to bring those issues to the attention of current leaders and work with them to develop ways of responding. They aim to bring new perspectives to these problems.

3.4. Synopsis of Report on Deterring Financial Reporting Fraud – A Platform for Action

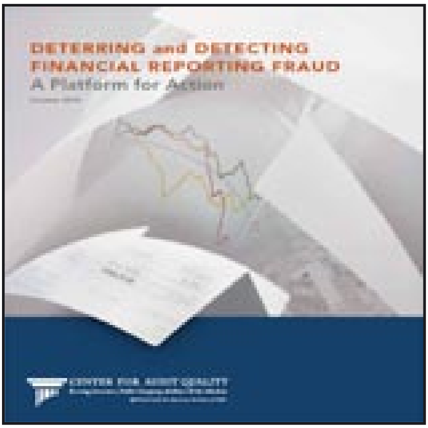
by the Center for Audit Quality[1]

Prologue: Financial Reporting Fraud – What it is and why the Center for Audit Quality Cares

On a number of occasions over the past few decades, major public companies experienced financial reporting fraud, resulting in turmoil in the US capital markets, a loss of shareholder value, and, in some cases, the bankruptcy of the company itself. The Sarbanes-Oxley Act of 2002 has done much to improve corporate governance and deter fraud; however, financial reporting fraud – an intentional, material misrepresentation of a company's financial statements – remains a serious concern for investors and other capital market stakeholders.

In 2009, the Center for Audit Quality (CAQ), which is committed to enhancing investor confidence and public trust in the capital markets, convened five roundtable discussions (four in the United States, one in London) with more than 100 participants, which were followed by more than 20 in-depth interviews, to capture views on fraud deterrence and detection measures that have worked and ideas for new approaches. The participants included corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, investors, regulators, academics and others.

In October 2010, the CAQ released *Deterring and Detecting Financial Reporting Fraud – A Platform for Action*, a report that draws from those discussions and interviews, considered in light of related research and guidance on the topic. The report contains ideas for lessening the risk of financial reporting fraud, related points to ponder and an extensive bibliography of fraud-related research. It represents a first step in longer-term initiatives and collaborations for the deterrence and detection of financial reporting fraud, to benefit investors and other participants in the capital markets.



Below is a synopsis of the CAQ's report, *Deterring and Detecting Fraud*, including ideas for increasing the ability of those involved in the financial reporting process to deter and detect financial reporting fraud. The full report is available for free download at http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf.

Chapter 1: Understanding the Landscape

Why Commit Fraud – The Seductive Triangle

Theoretically, anyone has the potential to engage in financial reporting fraud, including some individuals who had previous reputations for high integrity. Three factors, referred to as the fraud triangle, often combine to lead individuals to commit fraud: pressure or an incentive to engage in fraud; a perceived opportunity; and the ability to rationalize fraudulent behavior.

The CAQ's anti-fraud report discusses the top three pressures that can lead an individual to commit fraud: personal gain (including maximizing performance bonuses and stock-based compensation); the need to meet short-term financial expectations; and a desire to hide bad news. Opportunities for fraud usually are greatest when the tone at the top is lax or controls are ineffective, although even the best controls cannot completely eliminate the risk of fraud. Finally, individuals who commit financial reporting fraud must be able to justify or explain away their fraudulent actions.

Typically, financial misstatement or manipulation starts small, intended as "just a little adjustment" to improve results. But as the need to maintain the deception continues and one misstatement leads to another until the perpetrator is locked in, loses objectivity, and heads down the slippery slope to commit major fraud.

Historically, most major investigations of financial statement frauds have involved senior management, who are in a unique position to perpetrate fraud by overriding controls and acting in collusion with other employees. When fraud occurs at lower levels in an organization, individuals may not initially realize that they are committing fraud; they may see themselves as simply doing what is expected to "make their numbers."

Participants in the Financial Reporting Supply Chain and Their Roles in Mitigating the Risk of Financial Reporting Fraud

Management, boards of directors, audit committees, internal auditors, and external auditors make up the public company financial report-

The Sarbanes-Oxley Act – Legislation for Strong Governance and Accountability

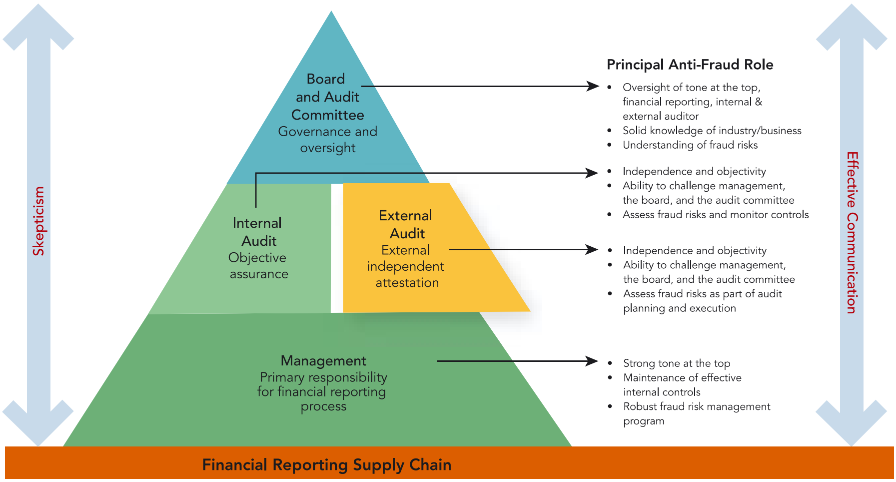
The Sarbanes-Oxley Act of 2002 was enacted in response to the corporate scandals of the late 1990s and early 2000s. The act mandated significant reforms to public companies' governance structures and the oversight of public company accounting firms. Many of its requirements were intended to raise the standard of corporate governance and lessen the risk of fraudulent financial reporting. In particular, the act:

- Reinforces the responsibility of corporate officers for the accuracy and completeness of corporate financial reports, and adds a requirement for the public certification of each periodic report filed with the SEC that includes financial statements. The chief executive officer and chief financial officer must certify that each such periodic report complies with the requirements of the Securities Exchange Act of 1934 and that the financial statements are fairly presented.
- Establishes criminal penalties for a willful and knowing untrue certification.
- Provides for the return of the bonuses and profits of executives involved in fraudulent financial reporting.
- Requires evaluations and additional information regarding a company's internal control over financial reporting by management, and a related report by the external auditor for certain companies.
- Requires other additional information, including whether the company has a code of ethics for senior financial officers.
- Increases the role of the audit committee, including requirements for financial expertise and responsibility for oversight of the company's external auditor.
- Requires companies to establish whistleblower programs, and makes retaliation against whistleblowers unlawful.

ing process or supply chain and have complementary and interconnected roles in delivering high-quality financial reporting to the investing public, including the deterrence and detection of fraud.

Management has primary responsibility for the financial reporting process and for implementing controls to deter and detect financial reporting fraud. Boards of directors and audit committees are responsible for over-

Shared Responsibility to the Investing Public for Mitigating the Risk of Financial Reporting Fraud



sight of the business and the control environment. The audit committee oversees the financial reporting process, the internal audit function, and the company's external auditors. Internal auditors play a key role in a company's internal control structure and have a professional responsibility to evaluate the potential for the occurrence of fraud and how the organization manages fraud risk. External auditors must be independent of the company they audit and provide a public report on the company's annual financial statements, including—for US public companies with $75 million or more in market capitalization – an opinion on the effectiveness of the company's internal control over financial reporting.

Themes Related to Fraud Deterrence and Detection

How can those in the financial reporting supply chain individually and together mitigate the risk of financial reporting fraud? While there is no silver bullet, the report identifies three key themes:

- A strong, highly ethical tone at the top that spreads throughout the corporate culture is the primary line of defense and is one of the most effective weapons to deter

fraud. An effective fraud risk management program is a key component of the tone at the top.
- Skepticism, a questioning mindset that strengthens professional objectivity on the part of all participants in the financial reporting supply chain, is an essential tool in evaluating fraud risk and in deterring and detecting potential financial reporting fraud.
- Strong communication among supply chain participants, which is essential to a thorough understanding of fraud risk and to an effective anti-fraud program.

Chapter 2: Tone at the Top – The Power of Corporate Culture

A strong ethical culture starts at the top with a company's most senior leaders and flows through the entire organization, influencing all three sides of the fraud triangle. A strong ethical culture creates an expectation to do the right thing and counteracts pressure and incentives to commit fraud. It also supports well-designed, effective controls that reduce opportunities for fraud and increase the likelihood that fraud will be found quickly. In addition, a culture of honesty and integrity severely limits an individual's ability to justify fraudulent actions.

Point to Ponder
If internal audit is expected to assess and challenge the tone at the top of a company, is the function structured properly to maintain its objectivity? For example, if the career path of most internal audit staff (including in some cases the chief audit executive) is to rotate back into the mainstream organization, is there a conflict of interest that potentially compromises objectivity?

Management plays the most critical role in building a strong ethical culture. To do so, senior management must clearly communicate ethical expectations and visibly live by them. Importantly, employees need to hear the same messages from their direct supervisors, because they have the most powerful and direct influence on the ethical judgments of their employees.

Tone at the top is reinforced through the establishment of a comprehensive fraud risk management program with a readily available confidential whistleblower program. In fact, studies show that fraud most often is detected through tips. In multinational organizations, it is critical that ethics and fraud deterrence programs also account for cultural differences.

Boards and audit committees support and reinforce the tone at the top, in part by choosing the right management team. Audit committees oversee the financial reporting process, including monitoring fraud risk and the risk of management override of controls. Boards, through the compensation and audit committees, can review compensation plans, especially those for senior management, for unintentional incentives to commit financial reporting fraud.

The internal audit function tests and monitors the design and effectiveness of fraud programs and internal control over financial reporting. According to The Institute of Internal Auditors (The IIA), internal audit should operate with organizational independence, which commonly includes direct reporting to the audit committee and unrestricted access to the board and audit committee should matters of concern arise.

External auditors have the responsibility to plan and perform an audit to obtain reasonable assurance that the financial statements are free of material (substantive) misstatement, whether caused by error or fraud.

Point to Ponder
How can the board and audit committee identify when a previously strong tone at the top starts to shift and morph into something more receptive to inappropriate risk-taking or behavior?

Because external auditors work with a wide variety of people across many parts of a company's operations, they often have the opportunity to gain insights at various levels about the company's culture, as well as on the effectiveness of internal controls. They also can leverage their experience from working with multiple clients. External auditors can serve as a useful resource for boards, audit committees, and members of management who may not have a similar breadth of experience or training.

Summary of Considerations Related to Tone at the Top

For Management

1. Clearly state the organization's ethical standards in a set of core values and a formal code of conduct, and hold all personnel strictly accountable for compliance with the code. Enforce discipline for violations consistently across all levels of the organization.
2. Set the right tone at the top. Embed the code of conduct into the company's culture by "walking the talk" (e.g., leading by example), increasing communications and training, and reinforcing the standards at all levels of the company through appropriate management systems and processes.
3. Build a mood in the middle that mirrors the tone at the top. Emphasize the critical role of supervisors

in setting the tone for their direct reports and their teams by both word and deed.
4. Establish a comprehensive fraud risk management program, including a whistleblower program and fraud awareness training for all employees. Consider cultural differences in other jurisdictions. Assign responsibility for the fraud risk management program to an appropriate member of senior management, and assess the effectiveness of the program at least annually.
5. Internally communicate actions taken related to information received from the whistleblower program.
6. Design incentive compensation programs so that their structure does not unintentionally provide a potential motivation for misconduct or fraud.
7. Set and enforce high standards for compliance with internal controls over financial reporting, including careful monitoring and providing adequate resources to comply with established procedures.

For Boards and Audit Committees

1. Personally "walk the talk" of the company's core values and code of conduct. In other words, lead by example. Be visible outside the boardroom, and interact personally with employees at various levels to obtain their perceptions of the corporate culture and reinforce high ethical standards.
2. Adopt a strong tone of compliance, communicate it to the entire organization, and hold management accountable. Take decisive action against any member of senior management who does not follow the company's ethical standards and code of conduct.
3. Regularly review key strategies and business plans and assess the achievability of goals in light of current circumstances. Goals should be structured to avoid a rigid short-term focus that might push management or employees to commit fraud.
4. Establish a regular process for assessing management integrity, and do not let this activity become perfunctory.
5. Approve the internal audit charter and the annual work plan to make sure it is aligned with and addresses the committee's needs and its expectations for internal audit.
6. Review and understand the results of reports to the whistleblower program, focusing on complaints that involve senior management or reflect on the ethical culture of the company. Make good use of the internal audit function.
7. Evaluate ways to strengthen relationships between the audit committee and the compensation committee – either through overlapping membership, joint meetings, or audit committee chair attendance at relevant meetings

of the compensation committee – with the objective of designing compensation packages that promote ethical behavior, as well as providing incentives to meet financial goals and build long-term shareholder value.
8. Consider the role of the audit committee in evaluating performance and compensation of the chief audit executive, as well as the benefits of adopting a policy that the audit committee agrees with employment or termination decisions for both the chief financial officer and the chief audit executive.

For Internal Auditors

1. Work proactively with the audit committee to develop a clear, shared vision of the internal audit function in order to reinforce the integrity and importance of the function throughout the company.
2. Require basic fraud detection training, including the detection of financial reporting fraud, for all internal auditors.
3. If appropriate, consider allocating one internal audit position for a fraud specialist, ideally someone with appropriate experience and certifications.
4. Take an active and visible role in supporting the ethical culture, including evaluating hotline results, conducting ethics surveys of employees, and collaborating with other departments to address results and correct applicable findings. Analyze year-over-year changes in key metrics.
5. Evaluate soft controls and the corporate culture, including assessment of the company's fraud risk management program, and involve appropriate other departments in addressing the results.
6. Establish or otherwise ensure there is a formal process to educate the board and audit committee on the risks and red flags of financial reporting fraud, with a particular focus on the risks of management override of controls.

For External Auditors

1. Inquire of management and the audit committee how they integrate tone at the top through the entire organization and into the culture at all levels. Focus the discussion on the details of the company's communications and training programs, including the tools that help each level of management reinforce the desired messages with its direct reports.
2. Discuss with management and audit committee how they monitor the company's culture to confirm that it doesreflect the tone at the top. Ask what tools and methodologies are used, such as employee surveys and reports summarizing whistleblower program results, and what is done with the results.
3. Proactively engage the audit com-

mittee in discussing observations related to the tone at the top obtained as part of the audit, as well as on insights into ways to identify possible red flags and warning signs.
4. Provide management, the board, and the audit committee with examples of leading practices related to ethics communications, hotlines, and whistleblower programs to mitigate the risk of financial reporting fraud.

Chapter 3: Skepticism – An Enemy of Fraud

Skepticism involves the validation of information through probing questions, the critical assessment of evidence, and attention to inconsistencies. Skepticism is not an end in itself and is not meant to encourage a hostile atmosphere or micro-management; it is an essential element of the professional objectivity required of all participants in the financial reporting supply chain. Skepticism throughout the supply chain increases not only the likelihood that fraud will be detected, but also the perception that fraud will be detected, which reduces the risk that fraud will be attempted.

Management exercises skepticism by periodically testing assumptions about financial reporting processes and controls, and remaining aware of the potential for fraud, particularly if the organization is under financial pressure.

The foundation for effective governance and oversight by the board and its committees is skepticism in the form of vigorous and probing questions of management, the internal auditors, and the external auditors to find sources of bias. To do so, the audit committee first needs to acknowledge the possibility that bias may exist and that something may go awry, potentially even resulting in fraud. Good board and audit committee members know what techniques to use to evaluate management, how to ask the right questions, when to ask follow-up questions, and how to identify and assess possible "uncomfortable" behavior. Asking the same questions of various people is another way that board and audit committee members can assess the consistency of answers and obtain multiple perspectives.

To exercise skepticism effectively, members of the board and the audit committee must have a thorough knowledge of the company's business, including its industry, its competitive environment, and the key risks that may affect management's ability to accomplish objectives. In particular, board and audit committee members need to understand how their organization makes money. Because revenue manipulation and the acceleration of future results into the current period are the most common forms of financial reporting fraud, understanding what accounts for the company's revenue is critical to deterring and detecting financial reporting fraud. Audit committee members should be comfortable in asking probing questions and should use internal auditors, external auditors, ethics and compliance personnel, or others as sources of information to supplement what they learn directly.

For both internal and external auditors, skepticism is an integral part of the conduct of their professional duties. Because of their constant presence in the company and their intimate knowledge of the company's culture, personnel, and operations, internal auditors are particularly well situated to identify early signs of potential fraud, including signs that the external auditor normally might not be in a position to identify.

Professional standards require members of the external audit engagement team to discuss the potential for material misstatement due to fraud, which should inform the audit plan and the nature and extent of audit testing. The team should consider where the company's financial statements could be susceptible to

Point to Ponder
Whistleblower tips can serve as an important source of information about fraud and other misconduct. How can external auditors better use the data regarding the nature and frequency of whistleblower tips to enhance their fraud risk assessment?

material misstatement due to fraud, how assets of the company could be misappropriated, the possibility of management override of controls, and how management could commit and conceal fraudulent financial reporting. Skepticism also is central to the execution of the audit plan, as auditors must be alert to indications of fraud risks as audit evidence is evaluated and modify the audit plan accordingly.

Summary of Considerations Related to Skepticism

For Management

1. Acknowledge that fraud can occur and consider such risks as part of the company's risk assessment process.
2. Build skepticism into the culture. Establish a clear expectation that all levels of management will question and challenge all results for which they are responsible, with the specific intent of confirming that corporate standards of accuracy, excellence, and ethics were met.

3. Aggressively pursue the root cause of any deficiencies in controls, and take remedial steps promptly.
4. Monitor your company and benchmark it with others in the industry for the purpose of identifying indicators of fraud.

For Boards and Audit Committees

1. Confirm that all board and audit committee members have a strong understanding of the company's business and its industry. Use outside training and consultants as necessary, with the objective of teaching all members of the board and audit committee to ask probing questions about strategy and operations. Audit committee members should also have a working understanding of financial reporting, even if they are not financial experts.
2. Ask questions of management, internal auditors, and external auditors to extract potential concerns related to opportunities or incentives for financial reporting fraud.
3. Use face-to-face meetings whenever possible to obtain information, encourage open discussion, and assess non-verbal communications such as body language.
4. Actively oversee those aspects of the company's strategy and risk management program that affect financial reporting, with a specific focus on risks that could potentially create incentives for financial reporting fraud.
5. Question management in detail about its program for managing fraud risk, focusing on areas where management has identified the greatest vulnerabilities, including the risk of management override of controls. Ask management to explain how those vulnerabilities are being addressed and consider using internal audit to evaluate the effectiveness of management's activities.
6. Use the internal and external auditors as key resources. Have regular, confidential meetings between the audit committee and the chief audit executive, and perhaps separately with other senior members of the internal audit department, as well as executive sessions with the external auditor.

For Internal Auditors

1. Suggest to the board and audit committee specific ways in which internal audit can provide support, with a particular focus on the risk of financial reporting fraud.
2. Take the lead role in assessing the company's program to mitigate the risk of financial reporting fraud, and report annually to the audit committee on that assessment.

For External Auditors

1. Based on the fraud risk assessment developed in planning the audit, suggest questions in advance that

the board and audit committee may want to ask management.

2. Regularly evaluate internal communications and training programs to confirm that they adequately address the exercise of professional skepticism and the assessment of fraud risk.
3. Reinforce the importance of interviewing and inquiry skills in the audit process, including consideration of non-verbal communications.

4. Emphasize the value of checking with others as a means of obtaining sufficient audit evidence, and provide guidance on mechanisms and methodologies such as company communications to verify information.
5. Consider including in the brainstorming sessions individuals outside of the engagement team with industry expertise and those who have experience with situations involving financial reporting fraud.
6. Consider face-to-face meetings to obtain information, in order to encourage open discussion and assess non-verbal communications.
7. Encourage the academic community to strengthen the auditing curriculum's focus on professional skepticism and techniques for fraud detection.

Chapter 4: Communications – Knowledge Sharing to Deter and Detect Fraud

Each of the participants in the financial reporting supply chain has a separate but interconnected role in the shared responsibility to deter and detect fraud. Fulfilling this responsibility successfully requires using each participant's complementary activities by sharing information and concerns and identifying any gaps in the collective efforts to mitigate the risk of financial reporting fraud. Frequent, high quality communications enhance the knowledge and understanding of all parties, resulting in better questions and a constantly improving communications process. The audit committee is a hub for coordinating many financial reporting communications because it has primary reporting lines from management, the internal auditor and the external auditor. It is the responsibility of the audit committee to see that these communications work well. Adequate time on the board and audit committee agendas for all priority matters promotes open, two-way discussion and critical challenge rather than a superficial or minimalist approach.

In particular, executive sessions of the board and audit committee with the chief financial officer and key employees, the internal auditors and the external auditors are invaluable in providing all parties with a broad perspective on the company's financial reporting environment and the reporting culture, including whether controls are respected and complied with faithfully.

Executive sessions provide the opportunity for the audit committee to go beyond the review of financial reports and have open dialogue on "soft" topics such as corporate values, management style and the potential for financial reporting fraud. For example, when the audit committee is discussing the financial statements with management or the results of internal audit engagements with the chief audit executive, committee members may want to consider specifically asking about and probing the controls over financial reporting, including controls over management override. Conversations with operating personnel and with financial management below the top level can provide valuable insights into the company's culture and the risks it is facing. Audit committees should consider asking questions such as "Were you pressured to do anything?" and "What are you uncomfortable with?" If the person knows that his or her response will be held in confidence, they will be more inclined to share concerns.

External auditors are required to report annually to the audit committee on a variety of matters and audit committees are one source of input into an auditor's assessment of the risk of material misstatement in a company's financial statements and the related audit response. These communications should not be viewed as a routine compliance exercise, but rather as the starting point for an in-depth discussion of any matters that concern either the audit committee or the external auditors.

Of course, not all communications run through the audit committee; communications also regularly occur between management and the internal auditor, management and the external auditor and the internal auditor and the external auditor. In most organizations, the internal audit function reports administratively to a member of senior management and the internal auditor's activities serve a key role in helping management assess the effectiveness of the control environment and the risk of financial reporting fraud. Internal auditors should consider management's risk assessment and other input in developing its audit plan, although management should not limit the scope of internal audit's work. The Internal audit's findings and recommendations can provide management with important insights in assessing whether the intended tone at the top and ethical messages have permeated throughout the organization's culture.

The objectives and professional standards of internal and external auditors with respect to the risk of financial reporting fraud are similar and complementary. Internal audit's evaluation of management's fraud risk assessment, as well as the results of internal audit's testing of internal controls, are important to the external auditor's assessment of fraud risk and its planning of the external audit. Similarly, the results of the external audit may also inform the ongoing internal audit plan.

Participants in the financial reporting supply chain should work diligently to establish and maintain an environment of open and ongoing communication. The goal is to share knowledge, insights and concerns to enhance the collective efforts of all supply chain participants and make the whole greater than the sum of its parts. Communications also encourage collaboration among all stakeholders and stimulate continuous improvement in efforts to deter and detect financial reporting fraud.

Summary of Considerations Related to Communications

For Management

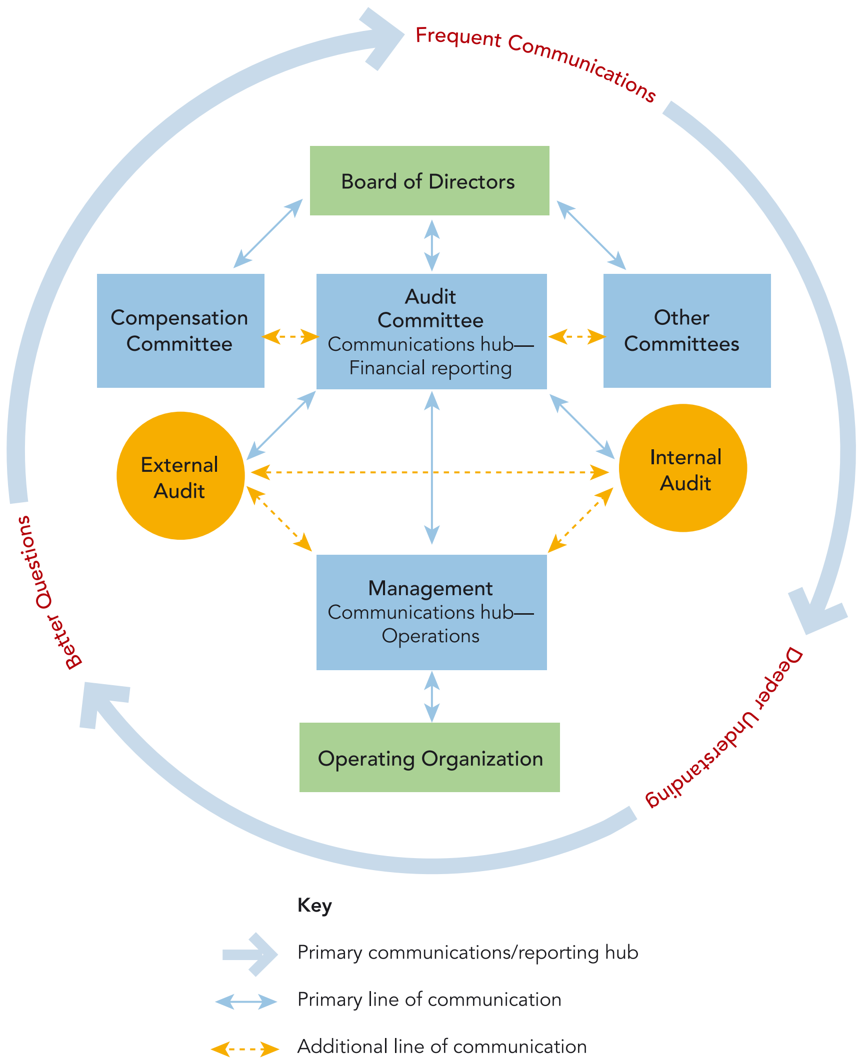
1. Encourage two-way communication between managers and employees at all levels in the organization.
2. Work proactively to make sure that boards, audit committees, internal auditors, and external auditors are well informed on a timely basis about the company's operations, strategies, and risks, including the latest developments.

Point to Ponder
There is almost never enough time on board and audit committee agendas, and yet time constraints should not limit critical discussions. What are the best techniques to ensure that all issues of concern to the board and audit committee are adequately discussed? One approach is to minimize opening remarks and formal presentations. What else works well?

For Boards and Audit Committees

1. Routinely ask questions of management, internal auditors, and external auditors to elicit indications of potential concerns related to incentives or opportunities for financial reporting fraud.
2. Work to connect with the organization outside the boardroom. Seek opportunities to interact with managers, employees, and possibly also vendors and customers to enhance knowledge of the company and possible risks of financial reporting fraud.

Financial Reporting – Lines of Communication



For Internal Auditors

Establish a regular schedule of face-to-face meetings with senior management, the audit committee, and the external auditor to exchange insights and perspectives. Explore opportunities for the external auditor to best use the work of internal audit.

For External Auditors

1. Proactively promote opportunities for robust conversations between the external auditors and the audit committee on relevant matters, including the factors considered in the auditor's assessment of fraud risk and the company's approach to developing significant accounting estimates. Seek an executive session with the audit committee at all meetings to encourage candid conversation, even when there are no special concerns or significant issues to discuss.
2. Work with boards and audit committees to vary the nature and focus of their questions to management, internal auditors, and others such as key employees in order to extend the breadth and depth of the discussion and obtain an enhanced understanding of the business and the potential risks of financial reporting fraud.

Chapter 5: The Case for Collaboration – Increasing Effectiveness across the Financial Reporting Supply Chain

While supply chain participants work to deter and detect financial reporting fraud one company at a time, the collective sharing of ideas and resources would greatly advance efforts to mitigate financial reporting fraud.

The CAQ believes that such collaboration would indeed enhance the ability of participants in the financial reporting supply chain to deter and detect financial reporting fraud and thereby sustain and enhance confidence in the capital markets over the long term. In addition to the discussion participants, the CAQ sought input on this report from Financial Executives International (FEI), the National Association of Corporate Directors (NACD), and The IIA, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud. Each of these organizations provided significant support and insights, and expressed interest in further collaboration.

The effort has thus far received a positive reception. In light of the importance of this issue to investor confidence, the CAQ will continue to encourage continued collaboration among these key stakeholders (and other professional organizations where appropriate) to better use existing resources, share ideas, and prioritize future activities to advance the deterrence and detection of financial reporting fraud. We anticipate that the results of these efforts will be transparent and inclusive, and will be communicated broadly to the key stakeholder groups. Such communication could be through white papers or other written materials, as well as the delivery of webcasts and conferences. In addition, we intend these efforts to complement the activities of the PCAOB's Financial Reporting Fraud Resource Center, and look forward to opportunities for collaboration with the new Center.

We are focusing our initial efforts in four areas:

1. Advancing the understanding of conditions that contribute to fraud

The fraud triangle does not explain one critical phenomenon: why one person takes actions to distort financial results, while another in a similar situation does not. Working together, the major stakeholder groups can use their current guidance, analyze past frauds, pursue further areas of research, and develop new materials to enhance understanding about the pre-conditions and indicators of financial reporting fraud. Building awareness in these areas could assist all financial reporting supply chain participants in identifying fraud risks and potential red flags, while at the same time further strengthening internal control systems. An important and related area for consideration is a greater understanding of the human conditioning that can prevent people from finding a fraud even when they sense that something may not be right. It will be important to identify and comprehend the environmental and behavioral factors that may discourage an individual from asking the next question that might uncover the fraud.

2. Promoting additional efforts to increase skepticism

All stakeholders could benefit from efforts to enhance the ability to think critically and skeptically about the information presented to them. For example, a key method used by stakeholders to identify potential indicators of concern is the review and analysis of a company's financial results and related complex information. Developing tools or techniques to enhance the ability of management, internal auditors, external auditors and audit committee members to evaluate a company's financial results (by comparison, for instance, with management budgets, analyst expectations, and the results of industry peers) could facilitate more robust discussions and help identify potential indicators of concern. In addition, frameworks to assist in assessing other potential fraud risk factors, such as compensation arrangements, could further enhance the review process. This could be complemented by enhancing stakeholders' communication and interview skills, and by examining behavioral traits or other environmental factors that may impede the application of effective skepticism.

3. Moderating the risks of focusing only on short-term results

An emphasis on short-term results can create pressures on multiple levels of an organization, which can increase the risk of financial reporting fraud. It is important that management, boards and audit committees, and internal and external auditors remain sensitive to the presence of and potential risks associated with short-term goals and take steps to lessen them. Stakeholders can share perspectives on short-termism, its role in the accomplishment of an organization's objectives (including those of investors), and its impact on a company's operating environment and system of internal controls. This awareness and sharing of experiences could allow all stakeholders to better understand and evaluate potential risks and mitigating factors, which would enhance their understanding of their respective responsibilities.

4. Exploring the role of information technology in facilitating the deterrence and detection of fraudulent financial reporting

Given its central role in systems of internal control, information technology can be helpful in deterring and detecting fraud. Technology also can be misused to facilitate fraud if not adequately controlled. Ongoing discussion of the benefits and challenges related to information technology could help all stakeholder groups identify and address technology-related risks for fraud. In addition, it would be beneficial to consider whether additional or improved use of technology would enhance internal control structures and assist in identifying potential fraudulent activity. For example, increased use of technology could facilitate the operation and monitoring of controls, lessen the risk of human intervention, and provide information about the effectiveness of controls. Exploring ways to enhance stakeholders' ability to use electronic information to identify possible signs of fraud could enhance their ability to detect fraudulent behavior. Focused collaboration could produce new ideas and tools, such as data queries and analyses that could be applied to general ledgers, sub-ledgers, e-mails, vendor master files, and other electronic repositories to assist in identifying potential fraud. Stakeholders in the financial reporting supply chain also may want to consider exploring whether a standardized data format for key elements of a company's general ledger would significantly facilitate the development of tools to assist in monitoring, analyzing, and evaluating financial information.

Conclusion

While there is no silver bullet solution to deterring and detecting fraud, every group in the financial reporting supply chain plays a key role in fraud deterrence and detection – from senior management to boards, audit committees, internal auditors, and external auditors. While the Sarbanes-Oxley Act has led to significant improvements in financial reporting processes and controls and overall corporate governance, all supply chain participants must maintain a vigilant watch for the presence of the elements of the fraud triangle.

The observations in this report represent the beginning of a focused and coordinated long-term effort to advance the deterrence and detection of financial reporting fraud, with the ultimate goal of benefiting investors, other users of financial reports, and participants in the capital markets. The CAQ is especially pleased that the FEI, the NACD, and The IIA have agreed to join with us to collaborate and advance this complex and vital issue. The CAQ looks forward to working with these and other stakeholders in these endeavors.

1 The Center for Audit Quality (CAQ) is an autonomous public policy organization representing a membership of approximately 700 public company auditing firms that is dedicated to enhancing investor confidence and public trust in the capital markets. Headquartered in Washington, DC, the CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. The CAQ is entirely funded by membership dues. Membership in the CAQ is open to US accounting firms registered with the Public Company Accounting Oversight Board (PCAOB) and others. For more information, go to www.thecaq.org

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3.5. The G20 Must Look Beyond Bretton Woods II
by Robert Zoellick

With talk of currency wars and disagreements over the US Federal Reserve's policy of quantitative easing, the summit of the Group of 20 leading economies in Seoul on November 11–12, 2010, is shaping up as the latest test of international cooperation. So we should ask: cooperation to what end?

When the G7 experimented with economic coordination in the 1980s, the Plaza and Louvre Accords focused attention on exchange rates. Yet the policy underpinnings ran deeper. The Reagan administration, guided by James Baker, the then Treasury secretary, wanted to resist a protectionist upsurge from Congress, like the one we see today. It therefore combined currency coordination with the launch of the Uruguay Round that created the World Trade Organisation and a push for free trade that led to agreements with Canada and Mexico. International leadership worked with domestic policies to boost competitiveness.

As part of this "package approach" G7 countries were supposed to address the fundamentals of growth – today's structural reform agenda. For example, the 1986 Tax Reform Act broadened the revenue base while slashing marginal income tax rates. Mr. Baker worked with his G7 colleagues and central bankers to orchestrate international cooperation to build private-sector confidence.

History moved on after the huge changes of 1989 and the experience of the 1980s is still being debated, but this package approach was significant for its combination of pro-growth reforms, open trade and exchange rate coordination.

What might such an approach look like today? First, to focus on fundamentals, a key group of G20 countries should agree on parallel agendas of structural reforms, not just to rebalance demand but to spur growth. For example, China's next five-year plan is supposed to transfer attention from export industries to new domestic businesses, and the service sector, provide more social services and shift financing from oligopolistic state-owned enterprises to ventures that will boost productivity and domestic demand.

With a new Congress, the US will need to address structural spending and ballooning debt that will tax future growth. President Barack Obama has also spoken of plans to boost competitiveness and revive free-trade agreements.

The US and China could agree on specific, mutually reinforcing steps to boost growth. Based on this, the two might also agree on a course for renminbi appreciation, or a move to wide bands for exchange rates. The US, in turn, could commit to resisting tit-for-tat trade actions, or, better, to advance agreements to open markets.

Second, other major economies, starting with the G7, should agree to forego currency intervention, except in rare circumstances agreed to by the others. Other G7 countries may wish to boost confidence by committing to structural growth plans as well.

Third, these steps would assist emerging economies to adjust to asymmetries in recoveries by relying on flexible exchange rates and independent monetary policies. Some may need tools to cope with short-term hot money flows. The G20 could develop norms to guide these measures.

Fourth, the G20 should support growth by focusing on supply-side bottlenecks in developing countries. These economies are already contributing to half of global growth, and their import demand is rising twice as fast as that of advanced economies. The G20 should give special support to infrastructure, agriculture and developing healthy, skilled labour forces. The World Bank Group and the regional development banks could be the instruments of building multiple poles of future growth based on private sector development.

Fifth, the G20 should complement this growth recovery program with a plan to build a co-operative monetary system that reflects emerging economic conditions. This new system is likely to need to involve the dollar, the euro, the yen, the pound and a renminbi that moves towards internationalization and then an open capital account.

The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today.

The development of a monetary system to succeed Bretton Woods II, launched in 1971, will take time. But we need to begin. The scope of the changes since 1971 certainly matches those between 1945 and 1971 that prompted the shift from Bretton Woods I to II. Serious work should include possible changes in International Monetary Fund rules to review capital as well as current account policies, and connect IMF monetary assessments with WTO obligations not to use currency policies to remove trade concessions.

This package approach to economic cooperation reaches beyond the recent G20 dialogue, but the ideas are practical and feasible, not radical. And it has clear advantages. It supplies a growth and monetary agenda that parallels the G20 financial sector reforms. It could be built upon prompt incremental actions, combined with credible steps to be pursued over time, allowing for political dialogue at home. And it could help rebuild public and market confidence, which will remain under stress in 2011. Perhaps most importantly, this package could get governments ahead of problems instead of reacting to economic, political and social storms.

Drive or drift? How the G20 decides could determine whether multilateral cooperation can achieve a strong economic recovery.

First published in the Financial Times, November 7 2010.

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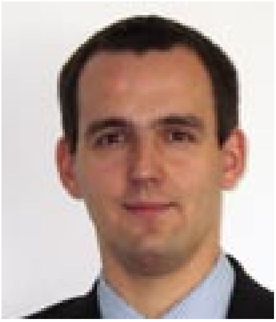
Mike Krzus is a partner with, Grant Thornton LLP. He is currently serving as the president of the Enhanced Business Reporting Consortium and he is one of the EBRC's delegates to the World Intellectual Capital Initiative. He is a member of the AICPA Assurance Services Executive Committee and past Chairman of the AICPA XBRL Assurance Task Force. Prior to joining Grant Thornton, Mike worked in the Assurance Professional Standards Group of Arthur Andersen. He focused primarily on U.S. and international standards for new types of attestation and assurance services. Mike's background includes diverse management experience in industry and public accounting. He has held positions including Year 2000 project director, director of internal audit and director of financial reporting for publicly held companies. In addition, Mike was in the national SEC practice of an international public accounting firm and was a director in the accounting and auditing quality control group of large Chicago-based public accounting firm.

Oliver Oehri, lic.oec.HSG, is a CSSP founding partner, Mr Oehri has taught internationally for several years on the subject of "Microfinance Investments". In his previous capacity, he developed and successfully implemented the first microfinance investment fund in Liechtenstein. Prior to this, he directed research in microfinance at the University of Liechtenstein. Mr Oehri is a board of directors' member of a Liechtenstein fund management company and as a committee chairman is responsible for fund management review/investment controlling. As an Associate Partner of the Fund-Academy in Zurich and as a financial consultant at a St. Gallen consultancy, he was able to amass profound theoretical and practical experience in the area of investment products. Mr Oehri has a graduate degree (Lizentiat) from the University of St. Gallen with an emphasis on financial and capital market theory. He teaches at the University of Zurich as well as at the University of Liechtenstein.



Maciej Piechocki is Senior Project Manager at the IFRS Foundation, the oversight body of the IASB. He is responsible for the technological development of the IFRS Taxonomy and the coordination of other global IFRS and XBRL initiatives such as the Interoperable Taxonomy Architecture project. Maciej is also involved in the IFRS Foundation's global outreach activities to promote understanding and adoption of IFRSs and XBRL.

Maciej is a member of the XBRL International Standards Board and the Taxonomy Architecture Working Group. He was an initiator of the Polish XBRL jurisdiction and the founding member of the XBRL Poland Association.

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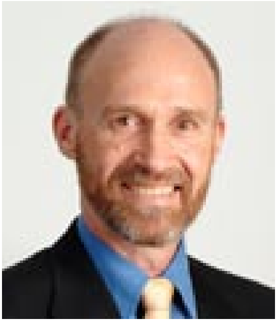
Kurt is a pioneer in global reporting languages and standards, having previously been a director and advisor to the International Financial Reporting Standards Foundation at the IASB in London for over 10 years. His work on behalf of the IASB involved introducing XBRL and IFRS to more than 70 countries. During his tenure with the IASB he served as the Global Chairman of XBRL and was a member of the EU Commission High Level Expert Group and the Brookings Institute Task Force on Intangibles.

Prior to joining the IFRS Foundation and its predecessor, the IASC, Kurt was a partner at PricewaterhouseCoopers in New York. He holds MBA, CPA, and CEBS degrees and is a board member of several international organizations and a member of the AICPA, Financial Executives International and other professional associations. Kurt Ramin currently serves as Treasurer on the Council of the International Union for Conservation of Nature (IUCN),



Cornelis Reiman applies international start-up, turnaround and business development skills as a Board-level advisor. Previously, he was President of an economic development entity promoting International Financial Reporting Standards in developing countries. Before that, he was Dean and Vice President of universities in Thailand and Singapore.

Formerly, he taught postgraduate international business, management and economics at Monash University. Prior to academia, he consulted in the private and public sectors on issues such as corporate management, strategic planning, regional economic development and business incubation. IBM and Arthur Andersen & Co. employed him earlier.

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Foundation of INNOVATIO Publishing Ltd. in 1985 to support the old idea of a Greek Agora with authors as Karl Popper, Helmut Maucher, Samuel Brittan: Journals, books, congresses with a focus on media monitoring, East-West Dialogue, culture management, and applied business ethics

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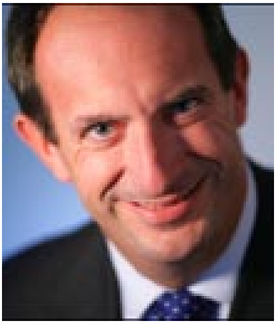

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XBRL International Steering Committee Member

Chair – XBRL International Jurisdiction Development Working Group

Liv A. Watson is one of the founders of XBRL and recently joined the Board of Director of IRIS Business Services Private Limited. IRIS is a leading information and technology player, which has been in existence for close to 15 years. IRIS' core strengths lie in working with unstructured information received from various sources, and standardizing and streamlining such information sets. IRIS has been very closely involved with the XBRL space, in the areas of taxonomy creation, software solutions and conversion of data into XBRL format.

She is serving on the board of directors of Media Tenor International.

Robert B. Zoellick

11th Chief Executive of World Bank

Mr. Zoellick was formerly Vice Chairman, International of the Goldman Sachs Group, and a Managing Director and Chairman of Goldman Sachs' Board of International Advisors.

In 2005-2006, Mr. Zoellick served as Deputy Secretary of the U.S. State Department. From 2001 to January 2005, Mr. Zoellick served in the President's cabinet as U.S. Trade Representative.

From 1993 to 1997, Mr. Zoellick served as an Executive Vice President of Fannie Mae.

Following Fannie Mae, Zoellick served for a year as the Olin Visiting Professor at the U.S. Naval Academy.

From 1985 to 1993, Mr. Zoellick served with Secretary James A. Baker, III at the Treasury Department (from Deputy Assistant Secretary for Financial Institutions Policy to Counselor to the Secretary); State Department (Undersecretary of State for Economic and Agricultural Affairs as well as Counselor of the Department).