

## Global Crisis: The Failure of Leadership



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***Transcript from Webcast with IMD President Dr John R. Wells***

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***Anchor: Paul Hunter***

PAUL HUNTER

Good afternoon and welcome to the second in our series of webcasts looking at the global crisis. A few weeks ago we looked at this crisis from a financial point of view; and technically how we got to the situation where we are today. Today we are going to be looking at that from a leadership point of view and asking the question “Has there been a failure of leadership?”.

I am delighted to be joined in our studio today by Dr John Wells, the President of IMD. John, many thanks for being with us today.

JOHN WELLS

It's a pleasure.

PAUL HUNTER

Let's cut to the chase: where we are today – is this a leadership crisis or a financial crisis?

JOHN WELLS

Well, first of all I would like to say it is not a financial crisis at all – it is an economic crisis. I find this attempt to try and constrain it to a financial crisis is a little unfortunate because all the financial system does is facilitate the exchange of physical goods. And the reason it creates value for those in that sector is because they arbitrage opportunities and therefore make the market more efficient. So they do a good job. But they are not creating physical goods value at all.

So the idea that you could have a financial crisis that is separate from an economic crisis is absurd. So the collapse of the financial system inevitably drives the production of physical goods into sort of disaster zone. So we have a major economic crisis around the world.

Now, the question is, is this a leadership failure or is it some interesting technical failure? It is a leadership failure. It is fundamentally a leadership failure.

And in order to understand that, we have to go back to what caused it in the first place. Historically, banking, lending people money – you have not separated the person lending the money from assessing of risk. A local banker lends somebody some money for a house; and they have to make an estimate of whether that person is going to repay them. If they do not make a good estimate, they have to live with the consequences.

But over time what has happened is the person actually offering the loan takes a commission for the loan, but doesn't actually have to bear the risk; they pass the risk on to somebody else.

By doing that, you have created a little bit of a moral hazard if you are not careful, because the person has an incentive perhaps to misrepresent the creditworthiness of the individual accepting the loan. And under those circumstances, loans can be made that are not really robust loans at all.

And so part of this crisis has been caused by agents in the field encouraging members of the public to misrepresent themselves; or actually misrepresenting them on their own behalf, by filling in forms with misleading information.

And by putting agents in that position one could easily predict this is the case; you are creating a context where this sort of thing is going to happen unless you track it very, very carefully.

But there are also instances where the system has said "You can have a loan. We don't need to know your income". Now, unless you charge a very, very high price for that that is going to cover absolutely everybody's risk, you are actually assuming an average pool, a risk pool there, and setting a rate on that basis.

Now, as anyone would know, in business, if you charge the same amount to everybody, you will get just those people that are worse. In economics it is called "adverse selection" – and you get an Nobel Prize for that; that is what Akerlof got - but in business, most businessmen have to make tradeoffs like that every day and understand it very, very well.

So pricing risk carefully is very, very important. So not to ask for the data in the first place is to actually expose yourself to an adverse selection problem; which some financial institutions systematically did - presumably because they thought they could pass that risk on to somebody else and take the commission for it.

So we have created a context which encourages people to make foolish decisions. So to deny that it was going to happen, or to deny that it was happening, would suggest either negligence or misrepresentation.

But then we would have these instruments. We pass on these instruments and we turn them into derivatives, and pass them on to banks. And we offer other institutions what is essentially a fantastic deal - you know, "You buy this paper, and it is Triple-A paper; and you will get a fantastic return on it".

Now, most normal people, when they are offered a fantastic return on something that is meant to be one hundred percent safe, smell a rat! So to turn around and say "Well, we didn't really understand them - but everybody else was investing too so it was OK, oh, and by the way, there was a company insuring them so we can pass the buck on the company AIG" - it seems to suggest, shall we say, a lack of responsibility on the part of the people buying the instruments in the first place.

And we are not talking about a few hundred million here; we are talking about tens of billions of dollars of paper that top management said "Well, we didn't understand it - therefore we went ahead".

So I think it is a leadership failure, on multiple counts. I think the institutions that were forcing loans on the poor in the first place, you know, one can turn round and say it is unwise; on another level, you can turn round and say it was theft.

Because the individuals that took those loans - no-one is going to bail them out; they are going to starve, they are going to be forced out of their houses. You know, they don't face the decision of whether they should turn their twelve million Swiss franc bonus down! You know, they face a much tougher decision.

And so it was robbery on the front-line. And so we took what was considered to be risk and spread it. What we actually did was we just spread rot. And those that accepted the rot on behalf of their shareholders have destroyed their shareholders' value - so at a minimum, being

negligent; but quite frankly, when you take a look at the systematic way people were buying billions and billions of dollars, and nobody raised the question - I think it is a leadership failure.

PAUL HUNTER

So a very sorry state of affairs that we found ourselves in now. You are suggesting, I guess, that greed is one of the motivations behind all of this. You talked about a lack of responsibility; since you have been here at IMD, one of the things that you have often brought to the fore is this notion of responsible leadership. Can you tell us what you mean; what do you understand by "responsible leadership"?

JOHN WELLS

Well I think it is a combination of getting the right results, but getting the results in the right way. I don't mean simply corporate social responsibility; it is a much bigger issue than that. Everybody in business needs to get the right results. If you don't basically get a decent return on capital, then you are not going to be able to raise more capital.

And it means you have to make some tough decisions. So it is not an easy position to be in as a leader; you have to make tough decisions. But whenever you make them, you must try and make them as responsibly as you can. You know, basing your decisions on the best information available would help; making sure that you are really creating shareholder value, as opposed to trying to meet short-term earnings expectations would help.

So just, as opposed to smoothing earnings, basically presenting earnings in an honest way would help. There are many instances in companies where people are making decisions that are not responsible. They are "stealing from the balance sheet", I call it.

There are instances where people are running a plant and they are not reinvesting in the plant - because by doing so they will make a super profit this year, be promoted and pass the problem on to the next person. That is not very responsible. It is basically essentially stealing from the asset base.

Driving a management team, or a team of young professionals, to the limits where they are having nervous breakdowns is not a good idea. You know, it is not a bad idea to drive people hard; as long as they are learning from it and you are building the people in the process. That is giving back as well as taking.

And so there are multiple instances in organizations where you see, in normal business practice, people essentially stealing from the balance sheet. The CFO smoothing earnings, you know - trying to represent the company as nice and stable or growing when it is not - is just dishonest. And it is too prevalent. We must be honest in our reporting.

But then of course, going beyond that, making sure that you look after your community if you can; you know, when you face a tough option, identify whether there is a way of avoiding that decision or having making less impact. Given the choice between of equal net present value - is it going to hurt the community or not? - you should always push to help the community; you should always try and contribute to society when you can and take a long-term view.

And because business is a multi-round game, we are all going to be here a long time; if we can take a longer-term view rather than just the very short-term view, rather than selfishness on the part of the individual or on the part of the company, I think we would all be better off.

PAUL HUNTER

And in your role as President of IMD, why have you particularly decided to champion this cause?

JOHN WELLS

Well, IMD has a strong tradition of responsible leadership. It was represented for the last fifteen years by Peter Lorange's saying, "If in doubt, do the right thing".

In our classrooms we teach responsible leadership; we encourage people to go through exercises, self-awareness and awareness of others; and essentially to make the right decisions and take a long-term view.

So this was a wonderful platform for me to champion this cause. Here is an institution that believes in it. And we all know that it is becoming increasingly important in the world; so let's put it to the front and the center and basically do good research on it, and also drive it forward.

We are a small institution - 300 people - and yet we impact nearly ten thousand executives a year in a thousand companies, in a hundred countries around the world. If we are going to impact them, let's make sure we impact them in a responsible way; such that we are getting the

message out there, “We can have an impact, and a significant impact, in providing a balanced view”. It is our responsibility to do so.

PAUL HUNTER

So when you talk about the opportunity, one of the things that we are doing next year, on the 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> of February, we are going to be running a Summit around responsible leadership, with faculty from IMD, with guest speakers from around the world. What is the thinking behind that? And people who come to that Summit, what can they expect from those two-and-a-half/three days?

JOHN WELLS

Well the first day, the afternoon of the first day, we are going to be focusing very much on the individual as leader and the responsibility they have to themselves to manage responsibly, but also managing their team in a responsible way.

We are then going to move on to a broader agenda of managing the corporation responsibly and the opportunities that represents, because there are many business opportunities in preserving the environment; corporate social responsibility – you can also create lots of shareholder value too; but also the challenges in making the tradeoffs.

And on the third day, we are going to be taking an even broader view – the global view, where we will have an awful lot more government regulation issues addressed, but we will also be looking at the business opportunities – for instance, selling to the bottom of the pyramid is not only good socially for the individuals that benefit from it; it is also a great business opportunity. Taking a small amount of money from the masses is often a very much more profitable approach in the long term than trying to make an awful lot of money out of a small number of people.

So again, very much a business perspective; but we will also be taking a look at the regulatory environment and the global perspective.

PAUL HUNTER

John, thank you very much for your time today. If you are interested in going further with that, if you would like to attend that responsible leadership, or if you feel that the failure of leadership in the current crisis is something that impacts you and you would like to have more information about moving forward and you would like to take an active part in that, then do click on the link just below your screen – you can get all the information there you will need about the Summit. Members of

our Corporate Learning Network, we have complimentary seats for you. If you are not a member of the Learning Network and you would like to come to that, click on the link and you will find all the registration details there.

John, thanks very much for your time and we wish you well on your campaign or crusade towards responsible leadership.

JOHN WELLS

Thank you.

PAUL HUNTER

Thank you very much.