

## Reject the Reset!

*Jed Emerson*

*The present crisis in global capital markets rolls on.*

And although it will be months—if not years—before we have a definitive analysis of the many practices that came together to drive recent events, a number of contributing factors are clear to many, including:

- a subprime mortgage market in which lenders provided credit to those without the means to support it, which culminated in a massive asset bubble,
- a misalignment of incentives that runs between those packaging investments, those buying them, and the firms that made use of the capital such investments provided,
- a decoupling of risk and reward through the extensive, misappropriate use of derivatives, which led to investors trading paper unconnected to the supposed value of the underlying assets,
- the subsequent warehousing of eroding assets in banks around the world, which has led to an asset-liability mismatch of gross proportions,
- a weakened regulatory environment that was allowed to evolve in the face of strong growth and political hubris.

Take your pick from the above list or a favorite list of your own, but the truth is, numerous factors played a significant role in a resulting capital blackout of massive proportions, the effects of which will be felt for many quarters to come.

As both the public and private sectors cobble together a hoped-for solution to this ongoing crisis, one word is consistently bandied about: reset. Many have suggested that we should reset the financial system clock to an earlier time when there was less leverage; to a time when we all thought we knew the value of a deal and the terms of investing. The notion of a reset suggests capital markets and their various actors on both the buy and sell side should be allotted a comprehensive “do over” to allow us all to return to this ethereal “time before.”

Such a call to reset would have us believe that, in truth, the core premises that led to our excess are somehow sound, that we simply got a little carried away in both our free-market rhetoric and artificially inflating charts of account. Calls to reset would have us believe this is simply a particularly bad part of the cycle and all that is required to overcome the current crisis is a chance to try, try again; perhaps with slightly lowered expectations and bank accounts, but playing the old game on a newly cleared table with a fresh deck of cards.

The problem with the concept of a reset is that it is not a revision, revisiting or reconsideration, but rather a return to prior practices and understanding of value. It speaks to dialing back certain corporate and investing practices, but it does not seek realignment of

incentives or to redefine the value proposition in a manner that speaks to the long-term interests of capital and communities. In truth, what is needed is not business as usual, but rather business anew, a reconsideration of how we think of not only finance and investing but capital systems and global economics. What is called for is a fundamental reframing of how we understand the nature of finance and capital markets.

As the mud clears and financial waters run anew, what is revealed is that rather than simply returning to the practices of the past, we have the opportunity to redefine how we understand investment options, types of return, and the notion of risk.

For example, during one recent conversation with a significant institutional investor, there was a moment when the conversation approached the surreal.

On the one side was the endowment's investment officer, charged with pursuing commercial returns, discussing how direct investments were down more than 30% and that the portfolio as a whole had taken an equivalent nose-dive.

Across the table sat the "social" investment officer, charged with managing investments for which financial return was not the only measure of performance, but where social and environmental factors were also taken into account. These constituted investments in community development finance institutions (CDFIs), as well as other "sustainable" investments; on the whole, investments their board considered "high risk, low return" allocations, but ones they believed important given the organization's overall mission. The social investment officer discussed how that portfolio's investments were up more than 5% during the same reporting period.

And in the middle sat their boss, trying to figure out how the mainstream markets had done so much damage while the "new alternative" products had performed so well.

The World Bank's International Finance Corporation defines sustainable finance along the following lines:

*Sustainable Finance integrates financial, social, and environmental considerations into decision making, facilitating improved risk management and higher return on investment. Financial institutions can potentially be affected by social and environmental issues through the operations of their clients. Social and environmental issues within a financial institution's portfolio may translate into business risks for the financial institution. There are three types of risk a financial institution could be exposed to arising from the social and environmental issues of their clients: credit risk, liability risk and reputational risk.<sup>1</sup>*

It is more than a little ironic that had the mainstream investment community been managing their portfolios along the lines of a more sustainable approach to capital investment, the current crisis might have been diluted—if not avoided in its entirety. Yet when it came to the subprime mortgage market, lenders were not focused on knowing the true risk or

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<sup>1</sup> <http://www.ifc.org/ifcext/sustainability.nsf/Content/SustainableFinance>.

debt-carrying capacity of underlying borrowers—and transparently communicating that risk to potential investors. Rather, mortgage lenders succumbed to the promise of easy fees and “cheap” credit, which laid the seeds of the current crisis, leaving banks around the world to deal with what is politely referred to as “asset erosion.”

Subsequent to the meltdown, some community development finance groups certainly find their borrowers and assets thrown into the common tumult of the current recession. However, prior to getting swept up in the waves of this recession, those investments were quite sound and performing well. These investments were (and most still are) of a steady and deliberate form, with lower financial returns but also carrying lower risk exposure than other commercial products in the investment basket. The risk carried by microfinance bond offerings, community notes, and other instruments has been lower because the focus of those structuring such deals was not on fee and profit generation, but on deeply understanding the market of inner-city lending and business development.

It would seem a central challenge and responsibility of traditional finance (to accurately assess, gauge, and price the risk and true value of traded products) was left to grapple with the significant shortcomings of its system. Meanwhile, a more cautious and, dare we say, sustainable approach to asset management and investing would have at least held out the possibility of managing risk in a more effective way that met a higher standard of fiduciary responsibility. This higher standard is one that acknowledges that responsibility is not simply to the pursuit of financial performance, but rather total returns. The responsibility is to also view these returns not simply as a function of numeric performance, but also with consideration of off-balance sheet risk, represented by a host of social and even environmental factors not traditionally considered in the calculus of mainstream finance.

If we are to not just regroup prior to taking another plunge off the next capital cliff, we must reframe our understanding of markets, capital, and finance toward a more holistic definition of value, risk, and return. We must seek to use new and proven tools of community finance and development, which offer financial performance with social and environmental value creation. And we must execute investment strategies that break down the wall between investments that are supposed to do well and those thought to do good. At its core, value is itself whole, a blend of various levels of financial performance and return with consideration of social and environmental risks. And the investment tools we may draw on come from a box much larger than we have traditionally thought.

Rather than a return to the practices of the past, we must reframe our understanding of the value we seek to create and the best strategies for doing so. We must reject the reset and engage in a collective reframing of how we invest, trade, and pursue the blended value generated from the diverse actors within our global, national, and local markets.

*Jed Emerson is managing director for Integrated Performance with Uburu Capital Management. He has held faculty appointments at Harvard and Stanford Business Schools, and is a visiting fellow with the Saïd School of Business, Oxford University.*