MARIE-CHRISTINE DUPUIS-DANON

Independent Consultant and Director of C3COM

Experience drawn from years of practice in assessing and analyzing the financial component of crime (mostly organized crime and terrorism) and financial crime itself (corruption, fraud, white collar crime and money laundering) shows that a great challenge for governance lies in the ability to detect, assess and sort out series of events to isolate long term trends and bring the international community to treat them with as much pragmatism as possible. In addition, early detection of problems is fundamental to open discussions with a cold mind.

We will discuss the role of governance bodies with respect to their *awareness raising function* to prevent major crisis.

Stability greatly derives from a global commitment to agree on a set of policy objectives and governing rules. It is commonly acknowledged that there is an acceptable level of divergence or marginality, which can develop without jeopardizing the whole system or putting its general balance at risk.

Therefore, it is of the responsibility of governance bodies to assess the weigh and influence of marginal forces, and to raise red flags when necessary. We have itemized three indicators of seriously destabilizing factors.

Red flag 1: the discrepancy between reality and its mental representation is growing unreasonably wide.

In economy and finance, too big a gap between the market value of goods or assets and their underlying value – what is commonly referred to as **"bubble" effects** – always leads to misallocation of resources and to brutal adjustments. Historically, this has proven true from the 1929 crisis to more recent crisis (stocks markets in the 80s, real estate in late 80s) etc. As globalization was resulting in markets expansion in volumes and players, as well as interdependence of national financial systems, these adjustments have been made at increasing costs. The climax is reached with the current crisis sparkled by the credit bubble bursting. Also see the recent crashes on e-economy, real estate markets, derivative markets, all driven by unbridled speculation.

Disconnecting from reality also corrupts, in an insidious manner, societies' inner values. There is a consensus among politician to point out the ethical dimension of the financial crisis due to a perverted form of capitalism derived from excessive speculation. Unquestionably, a **shift in ethics** occurred during the 90s as several factors contributed to increasing the volume and outreach of easy money: widespread use of badly designed compensation schemes (including stock options and golden parachutes), repeated deliberate violation of regulations and ethical standards by first rank financial institutions to maximize profits, misconduct of investment banks and auditing firms (creating or covering sham transactions in the Enron case - 2001). Going full circle, the perspectives to make huge profits supported forces for deregulation, which governance bodies failed to impede.

Red flag 2: groups of individuals, public or private entities or even states, supporting ideas, ideology or carrying action formerly considered to be anecdotal, gain in importance and influence to the point they can alter the power struggle and rock the whole system.

Obviously, States are better equipped to respond to traditional types of threats (territorial attacks, confrontation between States etc.) than to non-traditional yet unhinging menaces (crime thriving on the internet, transnational organized crime, market integrity threats and abusive market behavior, etc.).

A major challenge lies in **assessing the importance of a trend**, including its real current influence, likely evolution and real capacity to act out (Which groups are likely to cross the line between protestations and violent action?).
Denial or over magnification of a problem are equally wrong, damage the credibility of governments and governance bodies and move them away from finding a more appropriate answer. (For instance, over magnification of terror risks from "Al Qaeda" has led to inadequate qualification of the 9.11 attacks as being "acts of war" and inadequate answer by launching a "war on terror". On the opposite, there is a constant denial of the magnitude of money generated by criminal activities and the powerful grip of organized crime on legal economy).

To respond in a positive way to new developments of the world, major issues have to be addressed:

How to integrate emerging economies in the political, economic and financial governance of the world? (G8 vs. G14? P5 vs. Broadened Security Council? Reform of the IMF so that quotas – and voting rights – reflect the real economic weight of its member countries). Symmetrically, emerging economic powers do not consider yet that they are bounded by any "code of conduct" to acting is a responsible way towards the international community (undervalued China currency, aggressive attitude and deliberate opaqueness of some Sovereign Funds).

Red flag 3: complexity is the excuse for not understanding what is going on, thereby abandoning regulation and governance to experts belonging to the same "caste".

The growing technical factors in most matters are a reality and require a high degree of expertise. This had led to leaving it to experts to manage critical assets with limited oversight and obvious supervisory breaches. However, experts who have proven incompetent, as well as experts turned delinquents, have caused major damages to corporations or financial institutions (see rogue bankers' role in the financial crisis, massive losses incurred by rogue traders at Barings or Société Générale).

One of the lessons of the financial crisis is that supervisory bodies proved **wrong** to leave whole segments of international finance to **self-regulation** under the motives that what was going on was i) very technical and ii) fully under control. For instance, the bankruptcy of LTCM in September 1998 has not triggered a shift in policy towards hedge funds regulation. Significant growth in assets and liabilities harbored in opaque vehicles, combined with growth in the off-balance sheet activities of corporate and financial institutions, both made possible under self-regulatory regimes, have proven to be major ingredients for a mismanagement of risks.

Because of the complexity and the diversity of matters, **transparency** is one of the most important issues to increase the chances of control by the world civil society and create a form of self-censorship for those tempted to abuse their expertise and position to the detriment of the international community's best interests. Timely and accurate access to information limits mismanagement and wrongdoings. Note that Transparency International (TI) has become a key player in the fight against corruption by consistently promoting transparency.

Efficient red flag mechanisms (and these are only three examples of obvious indicators of malfunction) would already contribute greatly to a better prevention of both exogenous and endogenous shocks, thereby improving the overall stability of the world. A step forward is to work on a better use by governments and political leaders of guidance provided by governance bodies as their natural inclination is to react only when the crisis strikes...