ETHICAL MISCONDUCT AND THE GLOBAL FINANCIAL CRISIS

Elaine Sternberg*

Abstract
On both sides of the Atlantic, greed, the financial services industry and deregulation have been blamed for the ‘Global Financial Crisis’. The genuinely unethical conduct underlying it was actually much more fundamental, pervasive and pernicious; it was positively encouraged by lax fiscal policy and promoted by government-generated moral hazards.

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‘Turnover is vanity, profit is sanity and cash is reality.’
City of London maxim (FT 1992)

1. Introduction
On both sides of the Atlantic, business and especially banking have been blamed for what is now familiarly called the ‘Global Financial Crisis’, the ‘GFC’. One prominent article has described the investment bank Goldman Sachs as ‘a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money’ (Taibbi 2009). Such hyperbole is what might perhaps be expected from Rolling Stone. But equally extreme verdicts have been pronounced by supposedly more sober sources. According to a group that describes itself as ‘an independent and objective investment advisor serving wealthy families and select institutions in the US and internationally’ (Greycourt),

... the root cause of the crisis was the gradual but ultimately complete collapse of ethical behavior across the financial industry. (Curtis 2008, p. 1) ... there is a special circle in hell reserved for subprime lending banks... (Curtis 2008, p. 3)

Contrary to popular belief, however, the most serious ethical1 problems surrounding the crisis, and concerning finance, are not those of the financial services industry. The unethical conduct involved is actually more serious, more pervasive, and more basic.

The sources are important, because the crisis continues. In 2007 and 2008, the term ‘GFC’ referred mainly to the threatened failure of financial institutions; it was feared that confidence and liquidity would disappear in response to defaulting subprime mortgages and derivatives based on them. Since then, however, ‘GFC’ has come to encompass the subsequent fall in

*Senior Visiting Fellow, Beloff Centre for the Study of Liberty, University of Buckingham, and Visiting Scholar, University of Miami. Email: e.sternberg@ethicalgovernance.com

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housing and in share prices, the massive loss of jobs, and the slowing of economic growth. It thus includes the global recession and sovereign debt crisis that continue, and threaten to lead to stagflation.

This short article has three objectives. First, it will outline what constitutes ethical conduct by business. Second, it will suggest why finance seems so often to be associated with unethical conduct. And third, it will identify what conduct leading to and responding to the Global Financial Crisis was indeed morally wrong.

The conceptual and philosophical approach of this article is thus substantially different from most responses to the crisis, whose focus has instead been macroeconomic analysis, institutional design, and/or public policy, especially deregulation. Even commentators ostensibly dealing with ethics have characteristically just condemned greed (e.g. Tett 2009; Lewis et al. 2010), or deplored the absence of integrity. This article, in contrast, attempts to offer an analytical framework for identifying exactly what was unethical, and why it was.

2. Business ethics properly understood

To understand what constitutes ethical conduct by business, one must first understand what business is. Properly identifying the purpose of business is vital, because the values of business ethics are just those that must be respected for the business purpose to be possible. The specific objective that is unique to business, and that distinguishes business from everything else, is maximising owner (financial) value over the long term by selling goods or services.

Long-term views require operating over time, and thus confidence in a future. Confidence requires trust, so the conditions of trust must be observed: lying, cheating and stealing are therefore ruled out. Equally, owner value presupposes ownership and therefore respect for property rights. In order not to be ultimately self-defeating, business must be conducted with honesty and fairness, and without physical violence or coercion. Collectively, these constraints embody what may be called ‘Ordinary Decency’.

Furthermore, business that is directed at achieving its definitive purpose encourages contributions to that purpose, and not to some other; classical ‘Distributive Justice’ is also essential. Just as Ordinary Decency is distinct from vague notions of ‘niceness’, this concept of justice has nothing to do with modern attempts to redistribute wealth on ideological grounds. What Distributive Justice requires is simply that within an organisation, contributions to the organisational objective be the basis for distributing organisational rewards. Though the term ‘Distributive Justice’ may be unfamiliar, the underlying concept is widely recognised. It is implicit in the commonly accepted view that productive workers deserve more than shirkers; when properly structured, both performance-related pay and promotion on merit are expressions of Distributive Justice.

The key to Realist business ethics is very simple: business is ethical when it maximises long-term owner value subject to Distributive Justice and Ordinary Decency. If an organisation is not directed at maximising long-term owner value, it is not a business; if it does not pursue that definitive business purpose with Distributive Justice and Ordinary Decency, it is not ethical.

3. The prominence of financial problems

If business ethics is so straightforward, why do financial matters seem to present so many ethical problems?
One key reason is the sheer pervasiveness of finance. Since all business dealings involve finance, so do most business problems – including business’s ethical problems. Finance is not exceptionally problematical, but it is, in business, virtually inescapable; everything a business does has financial ramifications. Finance also suffers from many of the same features that make business itself seem ethically suspect. It is the locus of decisions that can involve vast sums and equally strong temptations, and its practitioners are often presumed to be clever manipulators of money and of men. And sadly, some prominent examples of financial loss have indeed been the consequence of moral wrongdoing, of deceit and outright theft. Even in such cases, however, the misconduct is typically reflected in finance; it is not intrinsic to finance.

Major business scandals tend to be associated with finance, because they are associated with financial losses. But it would be wrong to conclude either that financial wrongdoing is the cause of those losses, or that finance is especially unethical. Businesses – including banks – typically lose money because their products or their marketing are misjudged, or because their operations or their staff are badly managed. Such failures always have financial consequences, and are ordinarily expressed in financial terms, but they are not themselves financial shortcomings. Even when financial problems are at fault, and businesses suffer from bad debts or mismatched funding or undercapitalisation, the failings involved are more often the result of folly than of fraud. Indeed, unethical conduct in finance may be as much a response to financial losses as a source of them; it is when businesses are weak that the temptation to falsify results may be the greatest.

4. Bank conduct and the GFC

What does this Realist understanding of ethical conduct by business, and of the place of ethics in finance, indicate about financial institutions? In what ways, if any, did they act unethically, and contribute to the GFC?

Recall that according to conventional assessments, they were evil. According to one academic report,

During the second half of 2008 . . . all major world markets . . . were devastated by the aftermath of unethical lending practices by major lending institutions. . . . Prudence and ethics were pushed aside as greed overcame good judgment among mortgage lenders nationwide. (Lewis et al. 2010, p.77)

What exactly is it that they did wrong?

4.1. Greed

The first criticism that needs to be challenged is the suggestion that greed dominated all, and that its very presence rendered the associated acts immoral. Both claims are false. Greed is a motive, which undoubtedly did impel some financiers, and prompt some unethical conduct. But (even) financiers are motivated by all sorts of impulses other than greed: by peer pressure and pride, by fashion and laziness, by curiosity and by sincere wishes to exercise their creative talents and solve problems. Greed is in fact responsible for far fewer business actions, and a fortiori for fewer business evils, than is commonly supposed.

Moreover, even to the extent that greed is the operative motive, it is a relatively clean one: cupidity is, in an important sense, self-correcting. Those who genuinely want to acquire and
keep wealth will avoid conduct, including unethical conduct, that reduces wealth; the amounts of money the greedy seek may be unlimited, but the ways of achieving wealth are not.

Finally, and still more fundamentally, even when greed is the motive, it has no necessary effect on the ethics of the actions it induces: the moral status of an act is largely independent of the motive that prompts it.

4.2. Acts vs. motives

A motive is that which induces someone to act. It often refers to the personal, usually emotional, satisfactions that a person may seek in pursuing the objectives that define activities; a motive can also characterise the way in which definitive objectives are pursued. That which is done, however, the act that is actually achieved or accomplished, can usually be abstracted away from the doer’s motive and evaluated separately.

The same morally good act can be done from all sorts of motives. A person can, for example, save a child from drowning out of a love of children, or fear of being called a coward. He can do it because it is his job, or because it is his moral duty. He can do it out of hope for publicity or a spirit of protectiveness. He can even do it to spite the child’s murderous parents or to upset his rival lifeguards. Whatever the motive, however, a good act – that of saving a child’s life – has been performed. That would be true even had the lifesaver been wicked and his motives thoroughly vicious: had he pulled the floundering child out of the sea only because he wanted to kidnap it, the child would still have been saved from drowning. Similarly, in business, morally correct acts can be undertaken for all sorts of reasons. A firm can offer equal pay for equal work in order to champion justice or undermine the unions or simply obey the law. The moral rightness of acts is perfectly compatible with the full range of motives – prudence and ruthless selfishness as well as duty and altruism.

Similarly, all sorts of motives, even noble ones, can give rise to immoral acts; worthy intentions are no proof against ignorance or error or foolishness. Genuinely devoted to justice, and with the best will in the world, a jury may nonetheless send the wrong man to gaol and a manager may promote the wrong person. The moral quality of an act is not determined by the motive that inspires it. Acts motivated by greed are not necessarily immoral.

4.3. Subprime mortgages

But perhaps the problem highlighted by the Global Financial Crisis is that there is something wrong about particular financial instruments. Consider subprime mortgages.

One of the difficulties that hinders the proper assessment of subprime mortgages, is a general lack of clarity as to what they are. ‘Subprime mortgages’ are more accurately called ‘subprime mortgage loans’. They are actually a combination of two things: a loan to purchase real estate, and a mortgage, or conditional conveyance of property as collateral for the loan. Colloquially, however, they are regarded as a unit, and referred to as ‘subprime mortgages’.

There is, however, no generally accepted definition of what makes a mortgage loan ‘subprime’. The (US) Federal Reserve Board, Federal Deposit Insurance Corporation (‘FDIC’), Office of Thrift Supervision, and Office of the Comptroller of the Currency (‘OCC’) generally categorise as ‘subprime’ mortgages that are executed by borrowers whose FICO (Fair Isaac Credit Organization) credit scores are less than 660 (OCC 2001, p.3); the US Department of
Housing and Urban Development (‘HUD’) and (sometimes) the OCC apply the specific
designation ‘subprime’ only to the subset of those loans for which FICO scores are less than
Mae’), in contrast, classifies as subprime the mortgages it purchases from subprime originators;
it is unclear what renders an originator subprime. Also often classified as ‘subprime’ are
securities that are otherwise labelled ‘Alt-A’. These are pools of mortgage loans whose terms
are somehow deficient, because of the mortgages’ high loan-to-value ratio, interest only
payments, adjustable rates, and/or insufficient documentation. By mid 2007, 27 million
mortgages – c.50 per cent of all US mortgages – were subprime or Alt-A (Wallison 2011,
p. 451).

What is not disputed about subprime mortgages is that they are financial instruments. As
such, however, subprime mortgages are not the sorts of things that can themselves have a moral
status: a subprime mortgage can no more be ethical or unethical than a spoon can or a
thermometer. The proper objects of moral judgement are not artefacts, but people and their
actions.

What can be morally assessed are the uses to which objects are put; it is those evaluations
that typically characterise objects derivatively and colloquially. Artefacts that are themselves
morally neutral can be used in good or bad ways, to further good and bad ends; the same
candlestick that provides light can be used as an aggressive weapon. Artefacts can also be good
or bad ones of their kind, that is, well or badly able to serve their purposes. A good candlestick
holds a candle firmly in an upright position so that it sheds light; a bad candlestick lets candles
droop and drip.

Moral judgements concerning subprime mortgages properly relate to their uses and their
design. As business instruments, loans are ethical if they are directed at maximising long-term
owner value while respecting Distributive Justice and Ordinary Decency. A loan is most likely
to maximise long-term owner value for its issuer if its funding is cost-effective, and if it gets
repaid in full and on time. Timely and complete repayment are, in turn, most likely if the
borrowers are carefully selected.

When funds are lent for long periods, they typically need the additional security of collateral
to offset their higher risk. A good mortgage loan is one backed by property whose sale would
be sufficient to repay the lender promptly if the borrower defaulted on the interest or principal.
Additional requirements for a mortgage or any other loan’s being ethical are that the methods
used in generating and selling and distributing it be honest and fair, and involve no coercion.
A bad loan is one that fails to satisfy any of these conceptual criteria.

On what grounds, then, are subprime mortgages so often condemned? It cannot be that
their inferior quality came as a surprise: like ‘junk bonds’, subprime mortgages indicated their
deficiencies in their very name. Nor can their moral status simply reflect their being
substandard compared with ordinary, prime, mortgage loans. When subprime mortgages are
properly structured, so that they are likely to get repaid profitably, in full and on time (as
historically most were), they can still be good business. To compensate for the greater risk of
default resulting from the inferior credit quality of the borrower, or from more complex terms,
a good subprime mortgage typically bears higher rates of interest than better-quality loans,
and more restrictive covenants.

Nor can the problem with the subprimes be their supposed complexity. Loans with an
adjustable rate of interest are commonplace for other sorts of borrowing (e.g. commercial loans,
and credit cards), and are standard for non-US mortgages (including those in the UK). One hundred per cent mortgages and endowment mortgages (ones on which only interest is paid throughout the life of the loan, and the principal gets repaid by the maturation of a life insurance policy) have also featured in the UK . . . though they have been considered suitable mainly for the highest-quality borrowers.

The problem with subprime mortgages also cannot be the fact that they were pooled into securities and sold, rather than having been kept by the originating institutions. Originally initiated by a government agency, the Federal Home Loan Mortgage Corporation (‘Freddie Mac’), this practice has been condemned as ‘origination for distribution’. But what’s wrong with that? Most products (e.g. shoes, computers) are created with the expectation that they will be sold rather than kept by their producers. Nor does any special problem arise because the products distributed are financial instruments. There is a more than 40-year history of non-recourse securitised debt obligations based on, for example, car loans, credit card loans. They have been unproblematic, even though the vendors and purchasers of those securities equally had no responsibility for generating or monitoring the underlying, constituent loans.

The reason that the subprime mortgages associated with the global financial crisis (for simplicity, ‘GFC subprimes’) were so problematical, is that they were not properly structured. They failed to meet basic standards of prudent lending, and consequently suffered much higher rates of default than subprime loans had done historically. Unlike traditional mortgages, the GFC subprime mortgages were issued to borrowers whose credit quality was significantly lower even than that of previous subprime borrowers. In addition, the loans were typically structured without the protections that would normally have been included to compensate for less creditworthy borrowers.9

‘Know your customer’ is a basic banking principle. It is minimally prudent, in assessing whether large loans are likely to get repaid, to obtain basic information about the borrowers, and to demand evidence of their creditworthiness. Accordingly, loan applicants normally have to submit tax returns, personal and bank references, employment and residence histories, and other such documents, to supplement the information available from commercial credit scores and police reports. Such basic information was, however, seldom provided or even requested for recipients of GFC subprime mortgages. Indeed, so little evidence was there for many of those loans, that the borrowers were known colloquially as NINJAs: borrowers with No INcome, Jobs, or Assets.

A further defect of the GFC subprimes is that the inadequacy of the borrowers’ credit quality was not offset by the protections normally required in such circumstances. Usually, even prime borrowers are obliged to pay cash for a significant portion of the properties they purchase. Down payments normally serve two important purposes. They protect the lender against declines in the value of the collateral that would result from falling property prices. And they constitute a stake that the borrower stands to lose if he defaults on the loan. Historically, down payments of at least 20 per cent of the mortgaged property’s assessed value were required. But for many GFC subprime mortgages, no down payment at all was needed: those loans were for 100 per cent of the property’s purchase price. By making it possible for people with little or no savings to acquire property, minimal down payments made home ownership accessible to many who might not previously have had the opportunity. But by not requiring purchasers to risk any of their funds, it also strongly encouraged speculation, and helped to intensify both the property price boom and the number of defaulters.
Mortgage loans that are not properly structured and/or ones that are issued to borrowers with inadequate credit quality are very risky; there is a high probability that will not get repaid. To the extent that financial institutions made such loans, they did indeed act unethically. What was unethical, however, was that they violated the requirement to maximise long-term owner value: the mortgage lenders were insufficiently businesslike.

Generating defective products is seldom a good strategy for maximising owner value. Even if the defective product is sold off, and even if its purchaser has no recourse to the originator, a reputation for defective products is a serious business liability. Consider the damaging effect on Toyota sales and shares of fears that some of its models might have flaws. Though subprime loans were not as life-threatening as stuck accelerators, they could be – and indeed have been – detrimental to the wealth of bankers and the lives of banks. Why would lenders issue them?

5. Moral hazards

A key factor was the presence of moral hazards. A moral hazard exists ‘when the rules of an institution provide a positive incentive to do the wrong thing’ (Sternberg 1994/2000, p.103). Unfortunately, moral hazards and perverse incentives pervade the American financial markets as a result of government regulation.

One of the most basic is deposit insurance. Because depositors know that funds up to the FDIC limit are guaranteed by the US government, they have no incentive to entrust their savings only to prudent banks, or to monitor the operations of the banks holding their savings. In turn, the banks receiving such deposits are afforded a one-way bet. They can apply the insured funds to risky ventures in hopes of achieving high gains, confident that any losses will be made up by the US government.

A second moral hazard is provided by the government’s provision of mortgage insurance. To encourage lending to less qualified borrowers, the US government has long offered guarantees of mortgages through the Federal Housing Administration (‘FHA’). Banks need not be concerned about the borrowers’ creditworthiness, because the government covers the losses of defaults. By 2006 the FHA was the largest insurer of mortgages in the world, having guaranteed 34 million mortgages since its creation in 1934 (HUD 2006).

A third moral hazard is provided by the government’s guarantees of the major mortgage funding institutions. Fannie Mae and Freddie Mac raise money through the bond markets at preferred rates that reflect their status as Government Sponsored Enterprises. Using that money, Fannie and Freddie buy mortgages from lending institutions, thus supplying lenders with the funds to continue making loans. Prior to the GFC, Fannie and Freddie were ostensibly private corporations. But it was widely – and accurately11 – believed that they enjoyed government guarantees. Because Fannie and Freddie expected that any losses they sustained on the mortgages they bought would be covered by the federal government, they had little incentive to restrict their purchases to properly structured mortgages, or to monitor the mortgages they acquired.

Supporting housing is also behind a fourth moral hazard: tax relief on mortgage interest. This policy makes borrowing more attractive than saving, and makes real estate more attractive than other investments. It thereby distorts the market for housing and all alternative investments. As a result, both the demand for houses and the price of houses are kept artificially high.
Although these moral hazards significantly antedated the GFC, their effects were exacerbated by a series of government regulations that further skewed lending decisions. These regulations, constituting a fifth moral hazard, aimed at promoting home ownership for minorities. To that end, they obliged lenders to make loans to riskier borrowers, or suffer serious penalties.

Such hazardous regulation included the following (Pinto 2010):

1. The Community Reinvestment Act (‘CRA’), signed by President Carter in October 1977, outlawed redlining, the practice of refusing mortgages to everyone in a designated geographical area, without regard to their individual creditworthiness. Individual assessment was considered unnecessary, because it was thought that ‘low-quality housing and high levels of unemployment and welfare dependency made local residents unattractive as borrowers’ (Butler 2009, p. 53). The redlined neighbourhoods were typically poor, and often black or Hispanic.

2. In 1991 the Home Mortgage Disclosure Act (‘HMDA’) rules were strengthened to include a specific demand for racial equality. Rules in place since 1975 had already forced lenders to provide detailed reports about the identities of their borrowers; compliance was increasingly monitored by government-funded ‘community’ groups like the Association of Community Organizations for Reform Now (‘ACORN’).

3. In 1992 the Federal Reserve Bank of Boston published a manual specifying that ‘criteria that would normally reduce the chances of a loan being granted . . . should not affect lending decisions’ (Butler 2009, p. 53). Among the criteria excluded were a mortgage applicant’s lack of credit history, using loans or gifts as their mortgage deposit (FRBB 1992, p. 14), and using unemployment benefits as their basis for income (FRBB 1992, p. 15).

4. Also in 1992, the mission of Fannie and Freddie was changed from providing liquidity to the mortgage markets, to ‘supporting affordable housing’. This political objective overrode any interest in financial prudence; their criteria for purchasing mortgage loans were loosened accordingly. In 1999, HUD ruled that by 2001, the percentage of mortgages that Fannie and Freddie purchased in respect of loans for affordable housing had to increase to 50 per cent (Holmes 1999). In 2004, the requirement was increased: by 2008, loans to ‘low- and moderate-income families and underserved communities’ had to reach 56 per cent (HUD 2004). Not surprisingly, in 2008 Fannie and Freddie plun ged into massive deficit and collapsed . . . despite being subject to 236 government regulators (Butler 2009, p. 55; Redwood 2008).

5. In 1995, the Community Reinvestment Act regulations were amended (CRA 1995) to oblige lenders not just to avoid redlining, but also to ignore most of the traditional criteria of credit-worthiness in their loan decisions. Mortgages could now be any multiple of income; a person’s saving history was irrelevant; applicants’ income did not need to be verified; and participation in a credit counselling programme could be taken as proof of an applicant’s ability to manage a loan. Violation of CRA regulations could be a violation of equal opportunity laws producing exposure to actual damages plus punitive damages of $500,000 . . . Under the CRA, if a lender wants to change its business operation in any way – merging with another bank, opening or closing branches, or developing new products – it must convince the regulators that it will continue to make sufficient loans to the government’s preferred groups of borrowers. (Butler 2009, pp. 53–4)
The regulations above accompanied and exacerbated the progressive relaxation of standards exercised by the government housing agencies. FHA down payment requirements, for example, plummeted. On housing amounts over $25,000, they were 90 per cent in 1970, but a mere 5 per cent in 1980; only the first $25,000 qualified for a 3 per cent down payment. By 1990, however, if housing cost less than $50,000, the full amount was eligible for the 3 per cent down payment. (Monroe 2001, p. 46) Not surprisingly, the FHA, Fannie and Freddie routinely guarantee over 85 per cent of all new US mortgages (Economist 2011).

Damaging though these regulations and institutions were, an even more pervasive and destructive (sixth) moral hazard has been provided by lax monetary policy. Since 2000, the US Fed has kept US interest rates artificially low, and thus perverted the signals that would have been given by freely determined prices. Because low interest rates made mortgages appear inexpensive, people bought houses rather than other items. The demand for houses caused real estate prices to boom. Those inflated prices in turn made using houses as collateral seem safer than it was, and encouraged banks to make still more mortgage loans. Because interest rates were so low, however, banks could only maintain their loan yields by lending to ever riskier borrowers. But the seriousness of those risks was obscured, because inflation fuelled expectations that property prices would continue to rise.

This heavily regulated environment provided overwhelming government incentives for banks to make bad loans. But disastrous though government action was in precipitating the global financial crisis, banks were also culpable. They were complicit insofar as they succumbed to the government incentives: strong though the incentives to unethical conduct were, some banks successfully resisted. Insofar as banks and other financial institutions solicited or supported those regulatory constraints, they were guilty of even greater wrongdoing.

Government regulation always involves coercion; as such, it automatically violates one of the defining components of Ordinary Decency. ‘Predatory do-gooding’ is unethical even when prompted by ostensibly generous motives. It is wrong to take advantage of the less articulate, intelligent, or sophisticated to impose costs on them or others through paternalistic regulation. All government regulation has a heavy price: independent of any financial costs, coercive regulation limits individual liberty.

Were any of the other elements of Ordinary Decency violated? It would certainly have been unethical to generate loans by lying, or by cheating prospective borrowers. Most mortgage originators did not stand in a fiduciary relationship to their customers. But it would still have been unethical to misrepresent the costs or risks of taking on a mortgage, and wrong to pressure prospective borrowers to take out loans that they could not reasonably be expected to afford and repay.

Predatory lending, and abusive practices by lenders, are indeed unethical. But so is predatory borrowing: taking out a loan that one is not willing, able or intending to repay is a form of stealing. Similarly unethical is obtaining a loan on false pretences. But ‘liar loans’ were endemic. The requirement for honesty works both ways, as does caveat emptor. These moral criteria apply both to individual borrowers, and to financial institutions themselves. Financial institutions had no excuse for not understanding and properly evaluating the securitised obligations that they bought and sold.

Although the chief ethical error of most financial institutions was being insufficiently directed at long-term owner value, many also violated Distributive Justice. Distributive Justice requires that compensation reflect contributions to the organisational goal. In a business,
therefore, those who contribute to declines in owner value should not be rewarded for doing so. But most financial institutions – along with most businesses of all sorts – make pay independent of owner value. Even performance-related pay is often related to the wrong performances. Insofar as it is, however, compensation arrangements systematically create yet another kind of moral hazard.

If, for example, the number of loans generated is the criterion for compensation, then the number of loans generated is likely to increase . . . but so is the number of substandard, defective loans. It’s easier to generate loans if one isn’t concerned about whether they’ll get repaid; the range of target borrowers then includes the large population of likely defaulters.

For Distributive Justice to apply, the criterion for rewarding loan originators should be not the number of just any loans; it should be only those loans that genuinely increase long-term owner value, that is, those that can be made profitably, and that get repaid on time and in full. Since outcomes can’t be known at the outset, properly structured remuneration systems typically include an element of deferral. But the compensation of most bankers, both at the institutions originating the GFC subprimes, and the institutions that generated and bought the securities based on them, included few lagged payments. Insofar as they rewarded anything but genuine contributions to long-term owner value, they violated Distributive Justice.

Note, however, that even though such conduct was genuinely unethical – and even if greed was a significant motivator of it – the unethical conduct could not have reached the levels it did without government assistance: the funds to pay the undeserved salaries and bonuses were only available because of the moral hazards provided by US regulation. If the bad loans had not been covered by government guarantees, the banks that generated the bad loans would have had to suffer the consequences of their imprudent lending. When the loans were not repaid in full, the missing funds would have been lost to the lenders; the originating banks would have suffered a reduction in their shareholders’ equity, and possibly a run on their deposits. Unless they could somehow have attracted further depositors or investors, they would have had no funds available for improperly structured compensation or for making more bad loans.

Unfortunately, the damaging effects of market intervention go even further. Having contributed so greatly to causing the GFC, the US government has exacerbated the crisis through its response to it; it has made the crisis both more likely to continue and to be repeated. The government’s bailing out failing enterprises and defaulting borrowers constitutes yet another major moral hazard. By creating the expectation that other organisations would be rescued in future, the initial bank bailouts encouraged the continuation of risky behaviour; the inconsistent availability of bailouts, and dependence on political favour for receiving them, undermined planning. Moreover, in invalidating the contractual terms of the firms and loans that otherwise would have failed, the bailouts called into question both the sanctity of contracts and the rule of law.

Bailouts constitute major moral hazards, and are multiply damaging: they not only reward the profligate, but they do so by penalizing the prudent. Firms that should have failed because of their defective operations are shielded from the consequences of their unethical action; instead of going out of business, they are given subsidies. Benefiting from such preferential treatment, the defective businesses provide unfair competition to businesses that were properly run. The frugal and provident are taxed to supply funds for bailing out firms that should have been allowed to die.
Moreover, by not allowing failing firms to die, bailouts prevent market forces from exercising the correctives that would otherwise follow naturally; rather than alleviating or preventing crises, bailouts prolong and preserve them. Bailouts positively encourage unethical conduct. Furthermore, they have done so through coercive action (e.g. Judicial Watch 2009; Burns 2009; Calvey 2012). Organisations that accept bailouts share their immorality; those that seek them are even worse.

6. Collateralised debt obligations (‘CDOs’)

Commentators, however, have suggested that the real wrongdoing of the financial institutions came instead from

... the packaging, and leveraging, of these [subprime mortgage] loans by Wall Street financial companies. These companies leveraged these bad loans, and sold them to unsuspecting buyers as bundled investments in the secondary markets. (Lewis et al. 2010, p. 77)

Does this charge survive examination?

First, consider the packaging of loans. What is supposed to be unethical about collateralised debt obligations (‘CDOs’), aka mortgage-backed securities (‘MBS’)? Under either name, they are simply straight debt securities whose repayment is expected from the loan receivables collateralised by a pool of mortgages. In theory, this can reduce the associated risk, since the chance of default would be spread over a group of borrowers. If the investment banks and fund managers who bought them were ‘unsuspecting’, they were culpably negligent: they are supposed to be finance professionals, and the label ‘subprime mortgages’ should have made the constituents’ inferior quality evident.

What about the credit rating agencies? Didn’t they misrepresent some risky securities as being safe? If they knowingly lied, they did indeed act unethically. And if they lacked sufficient understanding of the securities they were supposed to be evaluating, they were culpably negligent. Unfortunately, while credit rating agencies have been increasingly regulated by government, their role has been transformed from useful gatekeeper into moral hazard.

Since 1973, the capital rules of the Securities and Exchange Commission (‘SEC’) have required a broker–dealer to write down the value of the securities on its balance sheet to reflect the securities’ level of risk. That risk is measured by the ratings the securities are given by a Nationally Recognized Statistical Rating Organization (‘NRSRO’), that is, one officially recognised as such by the Securities and Exchange Commission.

In designating the NRSROs, the SEC grandfathered existing firms (e.g. Moody’s, Standard and Poor’s), and deliberately excluded new entrants; it thereby created an oligopoly. Taking advantage of their entrenched, official status, the recognised rating agencies moved away from their historical practice of marketing and selling ratings largely to investors. They started selling ratings instead to the issuers of debt, whose interest was more in high ratings than in accurate ones.

Nevertheless, the obligatory use of the recognised rating agencies, and their consequent dominance, has been progressively reinforced. In the 1980s, the SEC extended their use from broker–dealers to money market funds, and from securities to money market fund holdings of
commercial paper. Bank regulators and state insurance commissioners have also increasingly required the use of NRSRO-approved securities’ ratings to satisfy their safety and soundness regulations.

Protected from competition by their position as a government sponsored oligopoly, the credit rating agencies have had little incentive to refine their credit assessment methods, or to ensure that their evaluations accurately reflect the levels of risk of the securities that they rate. Moreover, the status of the credit agencies as official, Nationally Recognised Securities Rating Organizations, and the fact that US governments have required the use of their ratings, has, albeit misleadingly, been widely taken to be a guarantee of the ratings reliability. Engendering such false confidence is another classic example of a government-created moral hazard: the regulatory rules themselves provide the perverse incentive.

But back to Collateralised Debt Obligations. It’s still not clear what’s supposed to be wrong with them. As commonly posed, criticisms of CDOs potentially raise any number of issues . . . of public policy, power politics and finance as much as of morality. In what way, for whom, are CDOs supposed to be wrong? For fund managers or potential home buyers? For investment bankers or commercial bankers? For investors? For regulators with political ambition? For the financial system? For the domestic or global economy? In aggregate for all of the above? Often, the public debate has not been about CDOs at all, but about the role of financiers, or resentment of high bankers’ bonuses, or frustration at financial complexity. The debate has also ignored the fact that holding CDOs rather than conventional mortgages was encouraged by bank capital requirements – yet another moral hazard.

The questions that are relevant to the conduct of individual businesses are much narrower: ‘Are CDOs a suitable investment for this portfolio?’ ‘Are CDOs the best way of this bank’s raising funds for continued lending?’ Such questions are much easier to answer, and may well give rise to no particular ethical perplexity. For the managers of equity funds, CDOs are inappropriate investments just because they are not equity instruments. Conversely, the manager of a CDO fund must invest in CDOs: doing anything else would violate his portfolio’s very reason for being. And for any person or institution – issuer or investor – who does not understand fully what CDOs are, and what risks they represent, CDOs are properly avoided.

Whether a particular business use of a CDO is moral will depend, as always, on whether it is compatible with maximising long-term owner value, subject to Distributive Justice and Ordinary Decency. That judgement is distinct from the moral assessment of the mortgages being securitised: the generation and use of CDOs can be unethical even if the constituent mortgages are unproblematic . . . and vice versa. Regardless of the status of the underlying mortgages, a mandate to issue CDOs will violate Distributive Justice if, for example, it has been awarded on the basis of anything but ability to maximise long-term owner value. Equally, Ordinary Decency will be violated if the terms of the issue have been misrepresented, or if investors have been coerced into buying. But if the CDO has been generated and distributed in ways that are compatible with maximising long-term owner value, and respect Distributive Justice and Ordinary Decency, it will be as ethical as an instrument can be.

7. Conclusion

In summary, then, there was indeed much unethical conduct surrounding the explosion of subprime mortgages. But most of it was quite different than that commonly supposed. Contrary
to popular opinion and media hype, the worst culprits were not greed, or a predatory financial services industry, or deregulation. Rather, the source was a pervasive irrationality – mainly by government – a systematic substitution of wishful thinking for a proper understanding of the objective reality that underlies markets and morality.

To the extent that banks and other mortgage issuers acted unethically, it was chiefly in being insufficiently directed at maximising long-term owner value. Instead, they jeopardised wealth by issuing loans that were improperly granted and structured. The defective loans were neither funded prudently, nor extended to borrowers whose ability to service and repay the loans was properly established; the loans were not backed with sufficient down payments or collateral, or protected by restrictive covenants. The financial institutions that issued such loans were thereby culpable. But their actions were largely a response to perverse incentives imposed by lax government economic policy and strong regulation.

The GFC was fostered and exacerbated by a plethora of government-created moral hazards: deposit insurance, mortgage insurance, government guarantees of mortgage funding institutions, interest relief on mortgages, progressive regulation to encourage ‘affordable housing’, nationally recognised credit rating agencies, and bank capital requirements. And underlying them all were the artificially low interest rates that persistently perverted market price signals.

Reactions by governments to the GFC have made things worse. Instead of reversing the causes that led to it, governments on both sides of the Atlantic have perpetuated and intensified the problems through bailouts and successive rounds of ‘quantitative easing’. Presented as ‘cures’, they have instead seriously hindered economic recovery, undermined private property, and threatened individual liberty.

Notes

1. Throughout this article, ‘ethical’ and ‘moral’ are being used interchangeably.
2. It has, for example, been suggested that the crisis might not have happened had banks been smaller, more local, precluded from securities business, or not corporate in form. For an analysis of bank shareholders’ liability, see Macey and Miller (1992).
3. For example, in the report prepared for the US Congress, the Congressional Research Committee summarised 29 ‘factors that have been identified as causes of the crisis’ (Jickling 2010). Ranging from ‘Imprudent Mortgage Lending’ to ‘Black Swan Theory’, the report made no mention of unethical conduct. Similarly, despite a press release claiming that the Federal Crisis Inquiry Commission had found ‘systemic breaches in accountability and ethics at all levels’ (FCIC PR, 2011), the index of the 633-page Federal Crisis Inquiry Report (FCIC 2011) showed only two entries for ‘ethics’. They referred to a mere four pages, three of which focused on Goldman Sachs.
4. A rare exception has been John Allison, whose talks to the (US) Federalist Society (Allison 2011) and elsewhere have offered an Objectivist account of the moral failings involved. See also Chapters 21 and 22 of his book on the financial crisis (Allison 2013), which argue that its deepest cause and the cure are both philosophical.
6. E.g. BCCI and ISC/Ferranti.
7. Because motives can apply to any purpose, they cannot serve to differentiate activities. When motive and intention appear to overlap, it is usually when intentions are derived from conventional understandings of motives.
8. Towards the child, the fish or even the body of water: he may wish to save the environment from disturbance.
9. In 2001, nonprime mortgages represented 10% of the US total. By 2006, the subprime share of new mortgage origination rose to 34%, bringing the nonprime share of existing mortgages to 26%. Meanwhile, the quality of loans within the subprime category declined, because a smaller share of nonprime borrowers made 20% down payments (down to 3% by 2004) (White 2008).
10. Increased from $100,000 to $250,000 by the 3 October 2008 Emergency Economic Stabilization Act, and made permanent by the 21 July 2010 Dodd-Frank Act (FDIC 2010; FDIC 2011).
11. ‘Fannie Mae is a government-sponsored enterprise (GSE) chartered by Congress with a mission to provide liquidity, stability and affordability to the U.S. housing and mortgage markets. . . .

Fannie Mae was established as a federal agency in 1938, and was chartered by Congress in 1968 as a private shareholder-owned company. On September 6, 2008, Director James Lockhart of the Federal Housing Finance Agency (‘FHFA’) appointed FHFA as conservator of Fannie Mae. In September 2008, we also entered into an agreement with the U.S. Department of Treasury that was most recently amended in December 2009. Under the agreement, Treasury will provide us with capital as needed to correct any net worth deficiencies that we record in any quarter through 2012. The agreement is intended to ensure that we are able to continue providing liquidity and stability to the housing and mortgage markets’ (FNMA).

Freddie Mac, created in 1970 to further expand the secondary market for mortgages, operates similarly.

12. ‘An innovative practice is one that serves low- and moderate-income creditworthy borrowers in new ways or serves groups of creditworthy borrowers not previously served by the institution. Both innovative practices and flexible practices are favorably considered. Although a practice ceases to be innovative if its use is widespread, it may nonetheless receive consideration if it is a flexible practice. An institution need not provide lending data connected with a practice in order to receive consideration’ (CRA 1995, p.22165).

13. Notably BB&T (Burns 2009) and Wells Fargo (Calvey 2012) in the US, and HSBC (Teather 2008; Dunkley 2009) in the UK.

14. For general arguments against government regulation, see Sternberg (1998/2004, pp.157–64). The claim is not being made here that unethical conduct would disappear in the absence of regulation: there will always be some people who do the wrong thing. But a key way of reducing unethical conduct is eliminating coercive regulatory incentives to act unethically. Removing such incentives is, indeed, the main (arguably, the only) positive way that governments can promote ethical conduct.

15. Insufficient disclosure constituted grounds for a successful class action against Wachovia in respect of its ‘pick a payment’ loans, aka Option ARMs (adjustable rate mortgages). There was inadequate warning of the potential ‘payment shock’ that could result when (typically low, ‘teaser’) rates increased, and the difference between the payment level chosen and the actual interest expense was added to principal, producing ‘negative amortization’. ‘Pick a pay’ was started by Golden West, which was acquired by Wachovia, which was in turn taken over by Wells Fargo (Benoit 2011).

16. It might be protested that in relying on government guarantees, and avoiding government penalties for non-compliance with regulation, banks were seeking to maximise owner value in the context in which they operated. Insofar, however, as banks’ operations could only be sustained through coercive government action, they were not business strictly understood. Business is the activity of maximising long-term owner value by selling goods or services, not maximising short-term profits by gaming government systems. Despite the various guarantees, from 1 January 2008 to 28 September 2012, 457 US commercial banks failed, vs only 11 banks in 2003–2007 (FDIC 2012). Investment banks Lehman Brothers, Bear Stearns, and Merrill Lynch were forced into bankruptcy; Fannie Mae and Freddie Mac were forced into conservatorship.

17. For Bear Stearns, Goldman Sachs, FNMA and FNMC but not Lehman Brothers.

Bibliography


