

The Current Subprime Financial Crisis: Ethics Issues and Potential Reforms

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"The end of ... economic (management) science is (to create) wealth" in such a way (praxis/action) "...that developmentally changes the actor and the external world." That is, the purpose of business is to create wealth in a way that makes the manager a better person and the world a better place.

Also, many of these securitized debt packages are made with much higher leverage than the traditional bank capital reserve requirements of 15-20% against deposits and are recorded as off-balance sheet items rather than loan assets. This is also a controversial issue. Should banks be allowed to not count such securitizations in determining their reserve requirements? There is an emerging consensus that they should not. A key reason for why these deals are made is that the commissions and fees on these deals for the issuing, primary financial institutions can be quite high. For example, if one financial institution invests \$1 billion and borrows \$20 billion (twenty to one leverage which is very different than traditional 15-20% capital requirements) to finance a sub-prime, securitized, debt deal that gains 2% or \$400 million in fees and commissions and another financial institution receives 1% or \$200 million in commissions and fees for passing on the deal to someone else, that can be 60% profits on the original \$1 billion investment. However, if the deal goes sour such that the value of the deal declines by 15%, \$3 billion, before it can be passed along to someone else, there is a \$3 billion loss and the initial capital is wiped out. If the financial institutions do enough of these deals, they can either go broke or be bailed out by Central Banks.

Bill Gross, the founder and co-chief investment officer of the \$100 billion plus bond mutual fund company, PIMCO, calls this new type of banking a "shadow banking system (Gross, 2008: 32)." Gross (2008:32) explains that the current liquidity crisis was largely caused by the subprime consumer and corporate debt excesses and that "The most affected economies are the finance-based economies – the ones that depended on financial engineering. The U.S. is the prime culprit, and the U.K. is close in terms of its problems. These economies are paying the price as the so-called shadow banking system contracts. A normal banks reserves 15% against deposits. The shadow banking system of SIVs (structured investment vehicles) and financial conduits has no reserves." He concluded that "Financial engineering has run amok."

One characteristic shared by the junk bond financed scandals of the late 1970s and early 1980s, the savings and loan scandals of the late 1980s and early 1990s, the investment banking scandals of the early 2000s, and the sub-prime consumer and sub-prime corporate debt scandals of 2007-2008, is that many of the financial institutions can make more money from short-term commissions and fees for advising, arranging the financing, and trading the new types of large, securitized, and often highly leveraged sub-prime debt financial transactions than they could from returns on long-term assets (Baskin and Miranti, 1997; Beaud, 2000; Fohlin, 2007; Kane, 1985, 2008; Kindleberger and Aliber, 2005; Nielsen, 2003, 2008; Useem, 1996).

In order to reduce the exponentially negative effects of such large, subprime, and sometimes highly leveraged, broken deals for both financial institutions and ordinary people, the U.S. Federal Reserve has greatly reduced interest rates, offered lower cost financing to commercial banks, investment banks, brokerage companies, and mortgage companies, and offered to lend treasury assets to financial institutions in exchange for sub-prime assets. If this works, it will help bail out the people and the institutions who caused the problem (Morgenson, 2008; Guerrero, White, & Guha, 2008).

What is going on here and what is the Fed and some other central banks doing? Vincent Reinhart, former Director of Monetary Affairs of the U.S. Federal Reserve (the highest ranking staff position of the Washington office), has concluded that the bailout of financial institutions by the U.S. Federal Reserve was the “worst policy mistake in a generation” and that the bailout “eliminated forever the possibility the Fed could serve as an honest broker (Ip, 2008: C3).” Reinhart is not alone in his criticism of the Fed. Paul Volcker, a former head of the Fed, has concluded that the bailout went to “the very edge of [the Fed’s] lawful and implied powers (Ip, 2008: C3).” There is also some criticism within the finance capitalism industry. For example, Mr. David Einhorn, Director of the Greenlight Capital hedge fund, charges that “The owners, employees and creditors of these [financial institutions] are rewarded when they succeed, but it is all of us, the taxpayers, who are left on the hook if they fall. This is called ‘private profits and socialized risk’. Heads, I win. Tails you lose. It is a reverse-Robin Hood system (Stein, 2008: BU2).”

There are at least four important issues associated with this situation: (1) transfer of income and wealth from ordinary people to recapitalize financial institutions; (2) moral hazard; (3) transparency; and, (4) conflicts of interests.

1. Transfer of income and wealth from ordinary people to recapitalize financial institutions.

These types of bailouts can and have hurt innocent people and, in effect, transfer income and wealth from ordinary people to recapitalize financial institutions. People living on fixed incomes and people and organizations whose expenses are weighted toward imported commodities, products, and services can experience reductions in income and wealth as interest rates are reduced, inflation is stimulated, deficits increase, and currencies fall in value. For example, if someone is living on an income from a defined contribution type pension and receiving E15,000 in income from a “safe” 5% money market or short-term bond fund, and Central banks reduce interest rates to 3%, that person typically would have a 40% reduction in income to E9,000 a year. In addition, as the currency falls 50%, at least in part because of repeated such bailouts, commodities such as heating oil, gasoline, and food can increase in price by 50% while people’s incomes are being reduced by 40%.

2. Moral Hazard

This type of bailout with its potential negative effects might create an issue of “moral hazard” (Nielsen, 2008). Kindleberger and Aliber (2005), in the fifth edition of their classic book, *Manias, Panics, and Crashes: A History of Financial Crises*, explain as follows: “A key topic is ‘moral hazard’ – if investors are confident that they will be ‘bailed out’ by a lender of last resort [The Central Banks], their self-reliance may be weakened. But on the other hand, the priority may be to stop the panic, to ‘save the system today’ despite the adverse effects....The primary rationale for non-interference is the moral hazard that the more interventionist the

authorities are with respect to the current crisis, the more intense the next bubble will be, because many of the market participants will believe that their possible losses will be limited by government measures. The moral hazard argument is that intervention skews the risk and rewards trade-off in the minds of many ...by reducing both the likelihood and the scope of future losses” (2005: 19).

There can also be moral hazard within financial institutions. For example, several top managers of financial institutions, such as Charles Prince of Citigroup and Stan O’Neal of Merrill Lynch, were allowed to resign with hundred million dollar “retirement” packages when the subprime mortgage and subprime corporate debt incurred under their watch collapsed (Cohan, 2008). Gapper (2007: 9) explains, “But, by giving them shares they should not have been eligible to collect unless they had performed better, Merrill and City have damaged Wall Street. By doing so, the two banks have created moral hazard, which appears when there are incentives for people to behave in ways that undermine their own institutions or the financial system as a whole... You may shrug your shoulders at this point and reflect that Wall Street has always been like this. But you are wrong. When Salomon Brothers...fell apart in the 1991 Treasury bond scandal, its new leaders fired John Gutfreund, its risk-taking chief executive. Salomon’s bosses, including Warren Buffett, who stepped in as chief executive, refused Mr.Gutfreund any severance pay-off and even blocked him from exercising his option on the bank’s shares...That is how to discourage the others.”

There appears to be some validity to Kindleberger’s and Aliber’s analysis and worry about increasingly dangerous, bailout facilitated bubbles. This appears to be the situation today, and also for the last thirty years, with the U.S. Federal Reserve bailing out financial institutions, their investors, and top managers in the junk bond bust of the 1970s, the savings and loan bust of the late 1980s, the high tech bubble of the late 1990s, the investment banking scandals of the early 2000s, and the subprime mortgage and subprime corporate debt busts of the present. While all this has been going on over the last thirty years, it appears that ordinary people are, in effect, subsidizing the bailouts and transferring income and wealth to re-capitalize financial institutions while average incomes are stagnating and declining in real terms but upper 2% incomes are rising exponentially (Plender, 2008). It appears that we have been increasing “moral hazard” through Central Bank bailouts. Are we also facilitating a political-economy of “private profits and socialized risks”? If we can’t avoid subsidizing, bailing out, and re-capitalizing the financial institutions to some extent at the expense of ordinary people, at a minimum, we need better and stronger enforcement and regulations to protect against the recurring, exponentially negative effects of large, subprime, and often over-leveraging, bubbles, and bailouts.

3. Transparency.

One of the key issues, one that even many people within the financial services industry admit, is the essential lack of transparency arising from the private nature of many of these large and often highly leveraged subprime financial transactions. For example, in the large securitized, off-balance sheet, subprime structured investment vehicles and subprime financing deals that take publicly traded companies private, there are far fewer requirements to reveal much information about those deals. For example, since the companies are no longer public, annual reports are no longer issued, and Securities and Exchange Commission and Federal

Trade Commission reporting regulations are much less applicable. This is a big difference relative to traditional finance. Also, because many of these financial transactions are off-balance sheet and private, financial institutions and firms can choose which information about them is released, and to whom it is released. This lack of transparency itself makes it much more difficult to collect and evaluate data about these types of financial deals and thus to reach conclusions about their associated ethical and social issues. An analogy might be if the pharmaceutical industry could choose the researchers to which it would release the data the industry chooses to release about drug safety, prices, and economics.

To many, this is a serious problem. For example, a European Union (2007: 129) study concluded that many such financial deals “are characterized by an extreme lack of transparency, information asymmetry and lack of disclosure on all essential activities. In our modern European societies, this is in direct contradiction to the overall, general state of play of fundamental transparency in the real economy, as a basis for participation and responsibility of our people.” This study also noted research showing that asymmetric information “makes the market economy function inefficiently and certainly not optimally.” Other policy makers have noted similar concerns (Blitz, 2007: 1). Similarly, the *Financial Times* (2007: 6) noted that, some “Large corporations – which may employ tens of thousands – release as little information as start-ups with a small office and a payroll of 10,” and editorialized that “Deals that are done in the dark look dodgy. The public’s logic is simple – why keep it quiet unless you have something to hide?”

4. Conflicts of interests.

Conflicts of interest in subprime deals have to do both with self-serving behaviors relative to responsibilities to multiple stakeholders, as well as conflicts between groups with different interests. This is one of the key differences from traditional banking and finance. While many in traditional banking believed that they had to balance responsibilities to multiple stakeholders, it appears that many in the new banking believe they do not and instead can focus on short-term maximization of fees and commissions income.

This issue can be considered from the perspectives of the financial firms and their investors, depositors, the secondary buyers of the securitized subprime debt, the acquired firms, and the bankers who facilitate the securitized and sometimes highly leveraged transactions. At least in the short-run, large subprime deals appear to be very profitable for the initiating financial institutions, their managers, and their investors, particularly in periods of relatively low interest rates and ample credit. This is true not only in the U.S., but elsewhere as well (Smith, 2007). However, it is much less clear whether these large, subprime, highly leveraged, short-term profits are compatible with long-term sustainability with respect to the long-term effects on depositors and secondary investors who the deals have been passed on to, the acquired companies, and their stakeholders. There is some evidence to suggest that depositors, the secondary investors, the acquired companies and their other stakeholders such as employees, old and new bondholders, new owners, and society may suffer in the longer term.

In periods such as the late 1980s and again beginning in late 2007, when interest rates rose and/or credit became relatively tight, subprime deals and particularly highly leveraged

subprime deals appear to be much less profitable. Are these types of subprime deals only sustainable in periods of very low interest rates and high liquidity? The debt servicing requirements can be very large. When interest rates rise, interest costs rise exponentially. Also, when credit becomes tighter, it becomes much more difficult and costly to roll over and refinance the debt, therefore greatly reducing profitability and social security. This can do great damage to ordinary depositors, the secondary investors, the acquired companies, the stakeholders of the acquired companies, and society—as has been observed in the subprime consumer and corporate crisis that has evolved into a global financial crisis. As noted earlier, compensation can be very high in large, subprime deal making.

Potential Reforms/Solutions

Depending upon how serious one considers the problems analyzed in the discussion of ethical and social issues that are structurally related to the subprime consumer and subprime corporate debt situation, one could consider various types of reforms. Methods that have been used in various parts of the world, and that could be used elsewhere include: extending banking's capital leverage requirements to include off-balance sheet, securitized subprime debt; having voting shares of publicly traded companies be held by families and/or nonprofit organizations; government disapproval of highly leveraged subprime deals; extending the reporting requirements of on-balance sheet and publicly traded corporations to cover subprime; “clawback” protections for old bondholders; and, tying compensation of financial firms and managers to long term sustainability.

One method for reform would be for subprime and highly leveraged financing to be subject to the same types of capital margin requirements as normal banking (Gross, 2007; Jackson, 2007). This would remove the high leverage advantage of many subprime deals, which the literature suggests is a large source of their profitability. Some financial institutions would probably object to this because it would restrict their potential for superior, leveraged returns. The main argument in favor of this approach is that it would reduce the likelihood of high-leveraged induced financial crises, as occurs today in the subprime, highly leveraged mortgage and corporate debt situations.

A second method for restricting highly leveraged, subprime deals would be to reinvigorate family and/or nonprofit organizational control of voting shares of companies. For example, in northern Europe it is common for founding families of companies and/or nonprofit foundations to create and hold the voting shares of their publicly traded corporations, such as is the case with the Danish pharmaceutical company Novo Nordisk and the Swedish-Swiss furniture company IKEA (Jacobsen, 2001; Nielsen, 2003). In both cases, the families created, then owned, and then gave away to specially created nonprofit organizations the voting shares of their companies. In addition, the charters of the nonprofit organizations stipulated that they could not sell the voting shares. This enables extended family members to sell nonvoting shares of the company for purposes of new financing and/or income without losing control of the company to subprime, financed takeovers. Examples of companies in the US where families and/or foundations control the voting shares are *The New York Times* media company (family controlled) and the Hershey confectionary company (nonprofit organization controlled). A difference between Hershey, on one hand, and Novo Nordisk and IKEA, on the

other, is that the nonprofit corporation that owns the Hershey company (and which owns a large boarding school for troubled children and engages in other child social service activities) can sell the company if it wants to. But if the nonprofit corporation has in its charter a requirement to retain the voting shares, it would not be possible for a subprime, leveraged take-over of the company without the family's or nonprofit's permission, in cases where the charter allows a sale subject to approval. Some would object to such provisions, and are currently lobbying the European Union against them, because they consider them unfavorable to shareholder value interests. A key argument in favor of this approach is that such firms would be more likely to be managed for long term sustainability rather than short-run profitability. This type of method is less likely to be adopted in the U.S., because there are relatively few large family controlled businesses compared to other developed countries.

A third method for restricting highly leveraged, subprime activity would for central banks and governments to not approve deals, as has occasionally occurred in China, Germany, Japan, and Spain (Santini, 2007; Crawford and Tett, 2008). For example, governments have refused to sell former state-owned-enterprises to highly leveraged, subprime firms. Central banks have refused to allow the subprime financing deals and governments have refused to approve subprime take-over deals. In addition, governments have refused to allow banks to bypass through off-balance sheet accounting the capital requirements for highly leveraged loans.

A fourth method for reform would be to require that subprime deals meet the same reporting requirements as on-balance sheet deals and publicly traded companies (Blitz, 2007; Bruce, 2007; Financial Times, 2007). This would go a long way to improving the transparency problem. While many in the industry support some form of increased transparency, most members of the industry would probably object to such a requirement because one of the key advantages they claim is that they can lower costs by not having to gather and report as much information as on-balance sheet and publicly traded corporations (Lee, Dixon, & Cyran, 2007). In addition, some in the industry would probably object to this proposal since another advantage the industry claims is that fewer reporting requirements increases their flexibility and freedom of movement to increase profits.

A fifth method would be the requirement of "clawback" provisions for old bondholders (i.e., compensation for losses incurred because of changes in a company's capital structure) (Cass, 2007; Jackson, 2006). As discussed in the section on conflicts of interest, with respect to old bondholders, the value of their bonds typically suffers large declines when firms greatly increase the subprime, leveraged debt of the acquired company. An argument in favor of this reform would be to protect the interests of old bondholders. The industry would probably object to this provision for two reasons: (1) that "covenant-lite" provisions for established bond holders reflect the bond holders' free choices in investment decisions; and (2) that this reform would transfer potential income from investors to old bondholders.

A sixth reform would be a requirement to tie the compensation of financial firms to the long-term profitability of the financial deals. An argument in favor of this proposal is that since firms claim that their deals enhance long term profitability, they should not object to compensation tied to long-term profitability. However, since there is substantial data indicating

that subprime, short-term profitability is greater than long-term profitability, and since money received now is generally considered more valuable than money received later, the industry would probably object to this proposal as well.

Conclusion

Large and often highly leveraged, subprime consumer and subprime corporate deals are a large and important form of banking and finance, different in key ways from traditional banking and finance. There are very important and problematical ethical and social issues structurally related to this form. While many in the industry claim great benefits, on balance, it appears that there is a strong possibility that in the subprime system there is more narrowing of goals and destruction of balanced responsibilities to multiple stakeholders (even financial stakeholders such as old bondholders, depositors, and secondary investors) than creative value added. However, given the transparency problem, it is difficult to know for sure, and thus it is crucial to address the transparency problem. There may be practical methods for reform. Some of these methods exist, to some extent, in different parts of the world, and have been noted here. But there may be other approaches, possibly rooted in different analyses of the nature, foundation, and supports for this form of finance. How politically practical and realistic they are in any society will depend in part upon much better transparency and understanding of the form. In addition, the political feasibility of reforms will also be influenced by the enormous political contributions that the industry makes to political candidates across the political spectrum in many different countries. However, it does seem clear that there are enough indicators of potentially very serious issues that these reforms need to be seriously considered.

For the initiators of these large subprime deals who were surprised when the music stopped and they could not pass on the subprime packages to someone else, the old maxim still probably applies that it is difficult to cheat an honest man. However, for the millions of ordinary people and thousands of secondary financial institutions who have been severely hurt by these types of very un-Aristotelian economic activities, wealth has been appropriated rather than created. It may be time to move back to the future and re-emphasize the Aristotelian business ethics praxis of being ethical, effective, and happy in creating wealth in such a way as to make us better people and the world a better place.

In conclusion, I would like to quote a more recent Greek author and manager, Theodoro Papalexopoulos of TITAN in his address to the Stanford University Alumni Association, where he paraphrased Winston Churchill in observing that “Capitalism is the worst economic development system....except for all those other systems that have been tried from time to time.” It is important to understand and fix the current financial crisis in order to better realize the Aristotelian ideal for business ethics praxis of creating wealth in such a way as to make us better people and the world a better place.

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