



# Why moral failures precede financial crises

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## Abstract

**Purpose** – This paper aims to explore the linkages between greed and governance failures in both financial institutions and financial markets.

**Design/methodology/approach** – The paper described how innovation changed the US financial system through an analysis of recent events, and employs the philosophic concepts of hubris and greed to explain certain developments.

**Findings** – The development of the shadow banking system and opaque products was motivated in part by greed. These developments made governance at both the institutional and market levels extremely difficult, if not impossible. In part the findings are limited by the current opacity of the markets and the dynamics of events.

**Practical implications** – The implication of the research is to reinforce the need for transparency if the risk of innovation in the financial system is to be both identified and managed. The creation of central clearing houses and/or exchanges for new products is clearly indicated.

**Originality/value** – Understanding the linkages between greed, hubris and governance in the development of opaque products provides insights of value to those trying to understand the current crisis – from academics to practitioners.

**Keywords** Governance, Ethics, Financial markets, Banking, United States of America

**Paper type** Conceptual paper

## Introduction

Innovation and crises are endemic to the financial system and while every failure leads to significant regulatory improvement, it has never been enough to prevent the next financial crisis (see, for example, Laeven and Valencia, 2008; Rowe and Day, 2007). Yet, each crisis has unique elements and the current crisis cannot be understood without seeing how financial innovation fundamentally changed the financial system of the USA and consequently for those financial systems connected to the USA – essentially the globe. To this end, it is important to note that the drivers of the problems – structured finance products – were essentially creatures of the unregulated or lightly regulated side of the US financial system, where greed was unchecked (Johnson and Neave, 2008). While there was clearly a failure of regulation, it should be first seen as a failure in scope of regulation. But it is equally important to understand how hubris united with greed was instrumental in players working to create an unregulated market. What is stunning about the current crisis is that it is the result of governance failures of both the boards of financial institutions and markets despite significant regulatory reforms in the banking world – Basel II – and corporate governance in the USA – Sarbanes-Oxley (SOX). The lesson to be learned is that regulatory reform without ethical reform will never be enough.

The faith that public policymakers had resolved the major economic issues associated with business cycles and volatility combined with the private sector's faith in hyper-rational modern finance and unregulated markets (Lynch, 2007) created an



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environment conducive to the growth of greed. The arrogant faith in the new financial order led to a lack of attention to governance and ethics despite famous ethical failures and heightened regulatory concerns. While it is often said that success breeds success, long bull markets and excess liquidity breed over-confidence and an over-commitment to revenue-generating activities as opposed to control activities. In this environment of weak governance, unethical behavior flourishes. Management scholars have already faced tough questions about the ethical implications of their theoretical suppositions (Ghoshal, 2005), but the current financial woes have led to renewed calls for a more central place for ethical considerations in mainstream management theories along with new questions about the significant role greed and hubris tend to play in the practice of management. We believe that the time has come for researchers concerned with the financial system and the question of ethics to address explicitly the problem of greed.

### **“The Great Moderation”: hubris and the limits of rationality**

There was a belief that policymakers had created a new and less volatile world. Ben Bernanke in a 2004 speech talked about the new world of the “Great Moderation”:

The Great Moderation, the substantial decline in macroeconomic volatility over the past twenty years, is a striking economic development. Whether the dominant cause of the Great Moderation is structural change, improved monetary policy, or simply good luck is an important question about which no consensus has yet formed. I have argued today that improved monetary policy has likely made an important contribution not only to the reduced volatility of inflation (which is not particularly controversial) but to the reduced volatility of output as well. Moreover, because a change in the monetary policy regime has pervasive effects, I have suggested that some of the effects of improved monetary policies may have been misidentified as exogenous changes in economic structure or in the distribution of economic shocks. This conclusion on my part makes me optimistic for the future, because I am confident that monetary policymakers will not forget the lessons of the 1970s (Bernanke, 2004).

Unfortunately, the policymakers were not alone in their heightened self-confidence concerning their ability to manage the economy. The massive egos of many leaders, executives and aspiring executives of financial firms also played a role. The popular press abounds with stories of the arrogance of players in the financial world, both real and fictional (Bruck, 1989; Lewis, 1989; Stewart, 1992; Wolfe, 1987). Much of the arrogance is brought about by a blind faith in modern finance and perhaps the likelihood of government intervention if things went wrong. This may have been the lesson drawn by market participants from the 1998 crisis brought about by the hedge fund Long Term Capital Management (LTCM). Despite mounting evidence, the players at LTCM clung to the belief that their models were correct and that what was happening to them could not happen to them (see, for example, Lowenstein, 2000). But at the darkest moment, the Fed intervened, brought together the players, and found a resolution.

Nassim Nicholas Taleb’s attacks on the unfounded belief in the new “pseudoscience” in *Fooled by Randomness* (Taleb, 2005), *The Black Swan* (Taleb, 2007a) and the *Financial Times* (Taleb, 2007b) clearly demonstrate the need for humility, as well as art in risk management. There can be little doubt but that arrogance led many strictly quantitative financiers to underestimate dramatically the events that were unfolding in front of them. A blind faith in technical mastery of complex financial models left many

financial professionals so enamored with probability that they forgot about the uncertainty that was in the tail of their distributions. Perhaps one striking event in the current crisis will turn attention from computer screens to reality:

The turmoil in financial markets has taken hold of the strategically important trade in long-term interest rate derivative, pushing rates to levels once thought to be a “mathematical impossibility.”

[...]

On Thursday [October 22], the 30-year swap spread turned negative after briefly flirting with such levels earlier in the month. This implies that investors are somehow reckoning that they are more likely to be paid back by a private counterparty than by the government, which can print money (Mackenzie, 2008).

The arrogance born out of a belief in hyper-rational “scientific” models is especially striking given the recognition that modern economics has given to the field of behavioral economics and finance. The Nobel Prize in economics surely conferred intellectual respectability upon the field when it awarded the prize in economics to George A. Akerlof, A. Michael Spence, and Joseph E. Stiglitz for their analyses of markets with asymmetric information in 2001, followed in 2002 with the award to Daniel Kahneman for his seminal work on psychology and economics and Vernon L. Smith for having legitimized laboratory experiments in the field of economics. The evidence was there for all to see that hyper-rationalistic models needed to be applied with caution.

The evidence was not only there in theory but in past experience. In remarks concerning the LTCM failure and the Asian Crisis, Federal Reserve Governor Laurence H. Meyer (1999) noted that the correlations among markets behaved differently than expected by the market strategists. The correlation among the markets increased, and consequently heightened rather than lessened the impact of events. The belief in the random behavior of markets blinded market participants to the possibility of systemic issues tied to herd behavior. Yet, in 1841, Charles MacKay published *Extraordinary Popular Delusions and the Madness of Crowds* about earlier financial crises (MacKay, 1841). Greed has the power to transform random events into herd behavior.

### **What is greed?**

We now need to explore the concept of “greed” and why it is considered by many in our society to represent a less than virtuous trait (notwithstanding the fact that the “greed is good” mantra, popularized by Oliver Stone’s “Wall Street”, has been adopted without irony by some in the business profession). “Greed” is in essence a rather difficult concept that has engaged thinkers across all religious and philosophical traditions throughout history. In Western society, it is perhaps most notably associated with the seven deadly sins of the Christian faith, but Tickle (2004) notes Hindu, Buddhist, Taoist, Sikh, Muslim and Jewish sources which supports her assertion that every system has explored greed and all its “aliases” including (but not limited to) acquisitiveness, covetousness, avidity, cupidity, avarice, miserliness and simony. Tamari (1997) identifies greed as one of the two main sources of economic immorality and explains how traditional Judaism limits the harmful effects of greed through a divinely revealed code that provides a normative economic morality. In the Jewish tradition, economic activity and the acquisition of wealth can be viewed as virtuous

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undertakings, depending on the source and the purpose of the activity. In this light, business is good, economic growth is good, but greed is not.

Yet one does not need to refer only to classic religious traditions to find an intellectual and moral disdain for greed in all of its manifestations. Bragues (2006) has recently reminded business ethics scholars of the potential for Aristotelian virtue to inform our current debate on the place for greed in the practice of business. Generosity and magnificence are two virtues discussed by Aristotle and reinterpreted by Bragues (2006) that encourage morally minded individuals to pursue capitalist interests and even enjoy the fruits of acquired wealth without sliding into the vice of greed. Magnanimity as a business virtue in Bragues (2006) is illustrated by an individual manager who is not motivated primarily by the pursuit of wealth, but by nobler goals. In a similar Aristotelian spirit, Solomon (1993) explains that in opposition to a vice like greed, virtues represent the best in us and our communities, and the drive to excel for reasons that go beyond the simple pursuit of profit represents the most elementary of virtues appropriate to the discipline of management.

For this paper, we wish to propose a working definition of greed that is rooted in economic behavior while embracing a moderate position closest in spirit to the Jewish and Aristotelian traditions that view greed as a vice only to the extent that it serves to hamper the positive possibilities of economic exchange. We propose that greed in this context needs to be viewed as occurring in situations where an individual seeks an economic return of greater value than what her input should reasonably earn and in so doing imposes costs upon others. The other is harmed in this process because the other's ability to claim fair value is oppressed. In the context of the firm operating in society, greed is encountered when a firm attempts to avoid paying the full costs for its behavior (what economists call externalities). The pursuit of economic rents can therefore be virtuous provided that the economic actors respect the notion of mutually beneficial exchange as the ethical core of economic activity.

Virtuous management involves a delicate balancing act between seeking out and developing innovative techniques and behaviors while at the same time keeping these innovations in check to ensure that they are conforming to society's norms of ethical behavior. Financial innovations in particular can bring about significant and tangible social good in spurring economic innovation. For example, innovations in the financial markets have resulted in popular mechanisms that allow for houses to be made more affordable to the average family. However, these same financial innovations that offer opportunity for the average individual also have the capacity to tempt investors into irresponsible behavior motivated by greed and the potential of unusually high returns. Perhaps no financial innovation demonstrates this more clearly than derivatives, which allow individuals and firms to limit their exposures to undesirable outcomes or to gamble recklessly in the pursuit of high returns. In an ethical sense, financial innovation increases our opportunities to act as prudent, caring individuals, limiting harm to stakeholders such as employees, customers, and shareholders. But derivatives also create the opportunity to gamble on a massive scale.

What this means is that even if the financial innovations are ethically neutral, the actions of the economic actors employing these innovations are not. If we cannot or do not wish to limit financial innovation then we must be fundamentally concerned about the moral character of those in the vanguard of poorly understood innovations. While economists and regulators may focus on the knowledge problem, it is just as important to look closely at the moral character of the players because financial innovation

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creates new structural conditions with the possibility of doing both good and ill. In this context it may be useful to recall the desire expressed in the Lord's Prayer: "Lead us not into temptation". It is critical for management scholars concerned about ethics to understand the implications of the structural changes in the financial sector and to further understand that in many cases the only safeguard is the moral character of the financiers.

**The new world of banking: "the shadow banking system"**

While greed is a constant in human behavior it is important to recognize how the financial world changed and created new opportunities for avarice that had systemic implications. William R. White (2004) at the Bank for International Settlement has written of the phenomena of "marketization": the growing importance of financial markets compared to traditional financial institutions (e.g. banks). We need to realize the radical shift that has taken place in financial systems concerning credit facilities and risk transfer. The primary source of debt for firms has become the markets – or the "shadow banking system" as it has become known, and this has transformed the world of credit risk management (Rowe and Day, 2007). Moreover it is outside of US regulation. Christopher Cox, Chairman of the SEC, testifying to the Senate Banking Committee on September 23, 2008, made clear the role of lack of regulation in the current financial crisis:

The failure of the Gramm-Leach-Bliley Act to give regulatory authority over investment bank holding companies to any agency of government was, based on the experience of the last several months, a costly mistake. There is another similar regulatory hole that must be immediately addressed to avoid similar consequences. The \$58 trillion notional market in credit default swaps — double the amount outstanding in 2006 — is regulated by no one. Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market (see [www.sec.gov/news/testimony/2008/ts092308cc.htm](http://www.sec.gov/news/testimony/2008/ts092308cc.htm)).

Former Federal Reserve Chairman Alan Greenspan, testifying before the House Committee of Government Oversight and Reform, confessed that he had counted upon the self-interest of financial institutions to protect shareholder equity. It should be noted that such a faith in market governance was not without support. The failure of the hedge fund Amaranth in September 2006 was in many ways a precursor to the current wave of financial failures, yet it caused no such systemic problems. Amaranth was trading futures on an organized exchange where the exchange was the counter-party to Amaranth's contracts. As Amaranth started to get in trouble, the exchange forced the sale of Amaranth's contracts in a liquid market to maintain its margin position (Cecchetti, 2007). As a result of these forced sales, while Amaranth failed and its shareholders lost, there were no systemic problems. The exchange had the information and ensured that market governance worked. In governance terms, Amaranth's transactions were transparent to market participants. Such is not the case with many of the innovations in what has come to be called the "shadow banking system":

A plethora of opaque institutions and vehicles have sprung up in American and European markets this decade, and they have come to play an important role in providing credit across the financial system. Until the summer, structured investment vehicles (SIVs) and collateralised debt obligations (CDOs) attracted little attention outside specialist financial circles. Though often affiliated to major banks, they were not always fully recognised on

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balance sheets. These institutions, moreover, have never been part of the “official” banking system”: they are unable, for example, to participate in today’s Fed auction.

But as the credit crisis enters its fifth month, it has become clear that one of the key causes of the turmoil is that parts of this hidden world are imploding. This in turn is creating huge instability for “real” banks – not least because regulators and bankers alike have been badly wrong-footed by the degree to which the two are entwined.

“What we are witnessing is essentially the breakdown of our modern-day banking system, a complex of leveraged lending [that is] so hard to understand”, Bill Gross, head of Pimco asset management group recently wrote. “Colleagues call it the ‘shadow banking system’ because it has lain hidden for years, untouched by regulation yet free to magically and mystically create and then package subprime loans in [ways] that only Wall Street wizards could explain.” (Tett and Davies, 2007).

We wish to call attention to one particular aspect of this “unregulated” market: its opaqueness. The market for credit default swaps is essentially an over-the-counter (OTC) market with bilateral contracts between buyer and seller. In this market, there is no one monitoring all positions and enforcing margin requirements that act as a buffer. It must be recognized that the opaqueness of the market reflects a strategic choice by the participants. Participants could have chosen to create from the start the clearing houses and even exchanges that they are now considering (*The Economist*, 2008; Tett *et al.*, 2008). This would have made this market far more transparent. Yet, ignoring the potential risks of opaque markets, the participants opted for opacity. The opacity meant that even market participants were functioning in a world where the lack of information made it impossible to assess accurately the full credit risk of counter-parties and there was no mechanism to buffer mistakes.

The merger of the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT) hoped to challenge the OTC markets and become the clearing house for all on-exchange derivatives and move into the OTC market with its own products. Not surprisingly this has met with the opposition of major banks, which control 85 percent of global derivatives trade (Cameron, 2007). The response of the banks was to be expected – all firms seek to protect their profitability – but in this case, the greed for private profits led to extremely high public costs. Greed overrode considerations of creating the appropriate infrastructure of information disclosure necessary to ensure market governance. Interestingly, if market governance couldn’t work, neither could firm governance, since there was inadequate information on the positions taken by individual players. It should further be recognized that the many of the problems in the subprime mortgage market were also tied to improper governance related to lower levels of screening for securitized products (Keys *et al.*, 2008).

## Conclusion

The blind faith in markets being able to count upon self-interest to ensure self-regulation ignored major advances in the field of economics. Self-interest may well have guided actions but it was the form of self-interest which is at the heart of agency problems. It seems reasonably clear that while the shareholders were wiped out, many players at the institutions were considerably enriched during the process – even with golden parachutes. While there may be problems in implementing controls on executive compensation, it is hard not to believe that devastated shareholders are entitled to a certain level of righteous indignation. We believe that it is correct to believe that self-interest spelt greed can be counted upon – but it can be counted upon

in just the way that agency theorists fear. Greenspan's comments only serve to demonstrate how isolated insiders of the financial community had become to broader concerns.

The "shadow banking system" was a governance failure waiting to happen. First, how could the governance structures at firms such as Lehman have measured their exposure to credit risk given the lack of information decryd by Cox? Clearly the boards of the banks were not performing the oversight role that they owed to their shareholders. The failure of many institutions has once again revealed the governance problems that both SOX and Basel II sought to correct. The decision to opt for opaque markets was a strategic decision with serious consequences. Secondly, free market advocates must recognize that in order for free markets to function, there must be open disclosure of information. Market governance is impossible in the absence of relevant information.

The immediate challenge is to restore trust not only among financial institutions to restore the inter-bank markets, but also trust from the public. This is a tall order. Greed led to the governance failures at both the market and individual institutional level. Financial players who should have been committed to the good of the system in order to ensure that they could create wealth for themselves while improving the lot of others failed to recognize this obligation. Rather, greed and hubris led to the enrichment of the few to the cost of the many. It would be naive to believe that a moral renaissance is at hand and will solve all ills, so until that time we must enforce rules to promote the virtue of transparency to prevent shadow worlds in the financial system.

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