— ✤ CHAPTER ONE ✤ —

A Financial, Governmental, and Moral Crisis

Introduction

On Monday, September 15, 2008, Lehman Brothers, a prominent investment bank that traces its roots to 1850, declared bankruptcy and thereupon triggered a global financial crisis. Literally overnight, borrowing came to a standstill, and widely held assets could not be converted into cash. The liquidity crunch immediately crippled banks owning substantial amounts of securities linked to subprime mortgages and spread very quickly to every sector of the global economy and all types of debt securities. Unable to sell even normally safe and highly liquid investments, on Tuesday, September 16, 2008, the Primary Reserve Fund, the oldest money market fund in the United States, in an action eerily reminiscent of Depression-era bank runs, shocked the financial community by freezing customer accounts and indefinitely halting withdrawals. Ordinary consumers were thus harshly reminded that there were no safe havens for their savings in this economic storm, adding another layer of uncertainty and instability to the financial markets. Within weeks of the Lehman bankruptcy, the resulting shock to the financial system inflicted severe and long-lasting damages on the economy, throwing tens of millions of people out of work and slowing economic growth. Half a decade later, the global economy still limps along in the aftermath of the financial crisis.

The financial crisis sprang from a precipitous decline in the value of mortgage-related securities. The bursting of the mortgage bubble completely wiped out Lehman's capital base. Other venerable Wall Street institutions including Merrill Lynch and Bear Stearns narrowly averted total collapse through hastily arranged mergers with Bank of America and JPMorgan Chase, respectively. Virtually every major financial institution had massive exposure to the mortgage market relative to its capital base, and even those banks not in danger of imminent collapse suffered staggering losses severely limiting their ability to engage in ordinary consumer lending activities and basic interbank transactions. Because of the financial sector's centrality to capital and credit markets, the U.S. Congress authorized a $700 billion government bailout to prevent further failures and safeguard the financial system from total collapse.

The global financial crisis and the prolonged economic recession that ensued raise complex and vexing questions inextricably melding economics and morality. What are the economic and moral connections between Wall Street and the overall economy? How did we arrive at this point in history where our most powerful financial institutions and the putative engine room of capitalism thwart rather than promote our free markets, our prosperity, and even our social cohesion? What essential elements and systemic features of our financial system make it possible for a very few individuals to amass enormous personal wealth as they help plunge the rest of society into a deep and enduring economic recession, putting millions out of work? What can be done both within the financial community and by governments to repair the fractured relationship between Wall Street and Main Street? These are the economic, ethical, and public policy questions we address in this book.

Financing the Debtor Nation: A Brief Overview of the Origins of the Financial Crisis

The story of how Wall Street firms became "too big to fail" and had to be saved at considerable taxpayer expense has been much chronicled in once esoteric terminology that has become all too colloquial for ordinary citizens. The seeds of the crisis were being sown for years by overleveraged banks and pension funds from Mississippi to Dusseldorf that placed outsized and risky financial bets on the value of collateralized debt obligations (CDOs) packaged and sold by Wall Street firms and based on an unreliable stream of payments by overleveraged American homeowners holding subprime mortgages. CDOs are financial instruments created by Wall Street firms that divide debt instruments into slivers (tranches), each of which is entitled to a precisely defined slice of the future cash flows from the original pool of future payments. The most common debt instruments whose future cash flows were repackaged in this manner were mortgages – loans secured by real property owned by homeowners and investors. The classic CMO, or collateralized mortgage obligation, was created by pooling mortgages that were then repackaged into a wide variety of tranches, each with rights to precisely defined mortgage-backed cash flows. Consequently, each CMO slice had unique risk and return characteristics.

Ironically, the invention of CDOs was one of the most important and socially useful financial innovations of the late twentieth century. It allowed investors to precisely calibrate the mixture of risk and return they wished to assume when investing in debt-based securities. In this sense, CDOs represented an important advance in the efficiency of capital markets. CDOs also offered advantages to homeowners and borrowers by enabling substantial flows of capital into debt markets, thereby making it easier for consumers to access credit to help purchase everything from a car to a house. In 2004, for example, homeownership rates in the United States reached 69.4 percent. (It has since slipped down to 66 percent.) Of course, the flip side of this easy credit has been a spike in consumer debt and a high incidence of personal bankruptcy among overextended consumers – 1.5 million in 2010 alone. The fatal misstep inexorably leading to the financial crisis arose from the proliferation of CMOs based on subprime mortgages of borrowers with high credit risks based on debt payment history, income qualifications, or other actuarially based indicators. Further contributing to the magnitude of Wall Street's financial bet on subprime mortgages was the invention of synthetic CMOs or derivatives. Unlike the classic CMO constructed from real cash flows from real mortgages, derivatives used contracts to mimic the underlying economics of particular slices of actual pools of mortgages. Neither party to the derivative contract actually owned any interest in the underlying mortgages being referenced in the derivative contract. This methodological innovation unleashed exponential growth in the total mortgage-related debt market and dramatically increased systemic risk in the financial markets.

Catalyzing all this was a cavalcade of incompetence, corruption, and fecklessness. Rating agencies such as Standard & Poor's and Moody's assigned investment grades to subprime CMOs, thereby promoting the idea that financial alchemy devised by Wall Street wizards would enable investors to enjoy the high returns normally associated with risky investments with the security normally reserved for more modest financial returns; subprime loan originators such as Countrywide, Washington Mutual, and Ameriquest that cut corners on standards and documentation to feed the pipeline of mortgage-backed securities that Wall Street craved; mismanaged quasi-federal agencies such as Freddie Mac and Fannie Mae, which (utilizing below-market-rate capital made possible by an implicit government guarantee) purchased ever-increasing amounts of subprime mortgages from the originators, thus allowing them to make additional poorly documented and risky loans; mono-line insurers such as AIG, which failed to understand the individual and aggregate of risk they were creating by guaranteeing so many transactions for diverse institutional players in the mortgage markets; and of course the lawyers and accountants who saw, heard, and spoke no evil and who blithely papered over the whole fiasco. It should probably also be said that partial blame must go to some consumers who irresponsibly took out mortgages for amounts they should have known they would not be able to repay, although, to be fair, there were many other consumers who were duped and defrauded by loan originators into taking out loans that were inappropriate for them or contained misleading terms.

Although we do consider these various other actors, our principal focus in this book is on Wall Street, the group of large and powerful financial institutions that orchestrated the financial crisis. We also devote considerable attention to how the government facilitated and exacerbated the financial crisis – first by promulgating regulatory loopholes allowing the market for CMOs and derivatives to grow exponentially and without public oversight, and then by falling asleep at the wheel and being caught completely off guard by the gathering storm. Moreover, as we shall describe in greater detail, the unintended consequences of government policies helped sever the connection between Wall Street profits and free markets that had served the economy well for more than a half-century.

The 99%: Occupy Wall Street and Public Anger over the Bailout

For ordinary citizens, the specter of a $700 billion publicly funded Wall Street bailout was infuriating. Adding insult to injury, many Wall Street executives walked away with huge compensation packages. Even executives in financial firms that declared bankruptcy enriched themselves with outsized cash bonuses as the global economy was thrown into turmoil, and tens of millions of workers around the world ended up out of work. In 2011, that anger spilled over into the streets as Occupy Wall Street protesters set up tents in Zuccotti Park, just steps from the epicenter of capitalism. The group decried economic inequality (hence the rallying cry “we are the 99%”) and corporate influence over the government, but its principal eponymous target was Wall Street and the financial services industry. Some have questioned the efficacy and propriety of its direct action tactics. Nonetheless, Occupy Wall Street was emblematic of a broad public disaffection with the financial industry. According to the National Opinion Research Council, from 2006 to

2010, the percent of Americans with a great deal of confidence in banks and financial institutions plummeted 19 percentage points, from 30 percent to an all-time low of 11 percent. Harris Interactive reported that the percent of Americans with confidence in the people running Wall Street reached an all-time low of just 4 percent in February 2009.[1]

The heightened scrutiny of Wall Street revealed a disturbing picture of an overhyped and poorly managed industry whose business model is unhinged not only from the interests of clients and customers but also from the economic realities of the free market. Instead of bringing discipline and sober valuation to the markets, Wall Street recklessly led the orgy of speculation and greed. It created the problems and hid them from public view. Wall Street bankers engineered the Rube Goldberg-like financial instruments that exponentially increased the systemic risks of CMOs. In the years leading up to the financial crisis, Wall Street, the ultimate assessor of value for the rest of the economy, managed to hide its own financial performance flaws from the usually swift and harsh discipline imposed by the free market.

The historical association of the financial industry with Wall Street dates back to the Buttonwood Agreement. On May 17, 1792, twenty-four brokers met under a buttonwood tree in front of 68 Wall Street to found what is now the New York Stock Exchange.[2] However, Wall Street, as we conceive it in this book, is not delineated by a physical place – that half-mile-long cavernous lane running east-west at the lower tip of Manhattan in New York City. Our focus is on the functions essential to capitalism that traditionally have been performed by institutions located on Wall Street, to wit the raising of investment capital, origination of securities, pricing of assets and securities, trading, brokerage and investment advice, market making, and provision of liquidity, as well as the rendering of advice about mergers, acquisitions, and other corporate restructurings. In the United States, many of these functions might also be performed in Chicago, St. Louis, San Francisco, or Dallas, among other places. London, Frankfurt, Milan, and Tokyo each have long and distinguished histories as financial capitals. And today, of course, the capital markets are global and around the clock so that Shanghai, Mumbai, Sao Paulo, and other cities have emerged as important financial hubs. Still, however, the association of Wall Street with the financial industry in the global imagination is a strong one. Moreover, many of the institutions that engineered and were key players in the financial crisis – Goldman Sachs, JPMorgan Chase, Lehman Brothers, Merrill Lynch, and Bear Stearns – originated on Wall Street and, those that survived at least, still have their global corporate headquarters in New York City.

The gap between Wall Street's prosperity and society's overall economic welfare has been widening as a result of the transformation of its business model from a mostly customer orientation with a relatively small proprietary trading component to one in which trading operations have come to dominate its profit structure and, perhaps just as importantly, the attention of the brightest minds in the financial industry. At the same time, a number of developments have increased the sheer scale and scope of Wall Street firms, including, most notably, the repeal of the Glass-Steagall Act, which tore down the wall between investment and commercial banking. These tectonic transformations in the business model and industry configuration of the financial industry have been taking place over three decades. It took the financial crisis, however, to demonstrate that these financial behemoths posed a serious threat to capitalism itself.

The analysis and legal reforms enacted in the aftermath of the financial crisis have focused chiefly on reducing the systemic risks arising when banks become "too big to fail." For example, the Dodd-Frank Act of 2010, the principal legislation enacted to address the financial crisis, was specifically designed according to its preamble to "rein in Wall Street and big bonuses, end bailouts and too big to fail, [and] prevent another financial crisis."[3] The emphasis has been on preventing and containing the systemic consequences of bank failures. Hence, reform efforts to date have sought to decrease leverage, increase capital requirements, and prohibit certain kinds of trading activities by Wall Street firms – most notably principal transactions, where firms buy and sell investments for their own account. We, however, focus on another, equally significant revelation of the financial crisis: Wall Street firms are not only dangerous when they fail; they can do immense damage to the economy even when they succeed. Indeed, as we shall describe, Wall Street launched a financial Armageddon as it made record profits in the years preceding the crisis.

Wall Street today poses a systemic threat to free markets and to capitalism itself. Far from being the impartial engine room of capitalism, Wall Street subtly bends and molds the critical information pathways of the free market to suit its own financial interests. The Wall Street business model and financial agenda have become unhinged from overall economic welfare. The financial system and the economy as a whole need Wall Street to facilitate the accurate valuation of assets and efficient allocation of capital. These functions are crucial to economic expansion, prosperity, and employment growth. However, in the years preceding the financial crisis, instead of facilitating the functioning of free markets, Wall Street prolonged the housing bubble by short-circuiting the flow of accurate market information about the underlying value of mortgage-backed securities. That, in turn, prevented the market from becoming more efficient and quickly detecting the real estate bubble, ultimately raising the financial cost of the bailout and aggravating the human cost of the ensuing economic recession.

Why is it that Wall Street thwarts the free market and poses a threat to capitalism? The problem lies in Wall Street's duality as both an industry and a crucial cog in the larger international economic system. It is structurally and culturally incapable of imposing market discipline on itself with the same ruthlessness that it applies to other industries when performing its essential functions of valuing assets and distributing capital to its most productive uses. Although Wall Street has always had profit motivations, its purely private interests have become much larger and much more disassociated from the interests of its customers and clients. Modern financial firms are financial leviathans that depend heavily on proprietary trading activities for their profits. They are no longer primarily financial services companies. Profits from client and customer relationships are now less significant in comparison to profits from principal transactions, including proprietary trading.

Moreover, when Wall Street is inefficient even for brief periods, the broad negative impacts can be dramatic. There is a rippling effect throughout the entire economy. When its self-interest is at stake, Wall Street distorts the efficient allocation of capital and short-circuits the free flow of information vital to free markets. The long, deep, and socially destabilizing recession that has followed the liquidity crisis triggered by the Lehman Brothers collapse on September 15, 2008, is a testament to the vulnerability of the economy, particularly of workers and entrepreneurs, to Wall Street's lack of market discipline.

The Moral Crisis on Wall Street

Underlying this systemic disconnect between Wall Street profits and social welfare is a deep moral void within the caverns of Wall Street. Public perception of the personal moral values and ethics of Wall Street executives is at historic lows. Only 26 percent of Americans in an April 2011 Harris poll thought the people working on Wall Street were "as honest and moral as other people," as compared to 51 percent in 1997. In the same poll, 67 percent thought "most people on Wall Street would be willing to break the law if they believed they could make a lot of money and get away with it."[4]

The contemporary Wall Street era can be characterized, perhaps even defined, by the shift that occurred when financial firms began conceiving of their business not as customer dependent, but rather as a series of transactions with third parties who came to be known as counterparties. Indeed, the very proliferation of the term "counterparty" into the Wall Street vernacular signals a radical disengagement from an interest in, or dependency on, ongoing relationships with people and institutions who used to be called clients and customers in the days when investment banking, advice on mergers and acquisitions, brokerage, private client financial advice, and other customer-focused financial services constituted the focus of large financial institutions. In the minds of Wall Street firms, counterparties exist to fulfill the firm's profit ambitions, ambitions that have become increasingly short term and disconnected from the prosperity and sustainability of the general economy.

It would have been abhorrent for their professional counterparts of yesteryear to deliberately harm customers and clients. The modern Wall Street executive, however, seems morally untroubled even when products such as derivatives, swaps, and other sophisticated financial instruments sold to counterparties are virtually assured to result in losses for those counterparties. Lloyd Blankfein, CEO of Goldman Sachs, captured the essence of the new

Wall Street when he remarked, "We didn't have the word 'client' or 'customer' ... We had counterparties – and that's because we didn't know how to spell the word 'adversary.'"[5] Michael Lewis reports that Morgan Stanley executive Howie Hubler, according to one of several traders closest to him, "thought the customer business was stupid.... Hubler could make hundreds of millions facilitating the idiocy of Morgan Stanley's customers. He could make billions by using the firm's capital to bet against them."[6] One problem with this brave new world of "us versus them" is that no set of ethical principles and internal constraints has emerged to replace the older values that existed when Wall Street profits depended on providing financial services to customers. Wall Street today is morally adrift from its traditional values and a danger to itself and to all with whom it comes into contact in the broader economy. The infamous Goldman Sachs Abacus case (detailed in Chapter five) became an iconic and transformational watershed of Wall Street Values; it was shocking to learn that Goldman Sachs was deliberately selling to its customers a financial instrument that the firm had designed to become worthless. However, despite paying $550 million to settle with the Securities and Exchange Commission (SEC), Goldman itself – and indeed many other Wall Street professionals – steadfastly maintained that the firm had done nothing wrong.

There is more at stake in the separation of interests between Wall Street firms and their customers than simply the legal and moral duties firms might owe to their customers. The investment banking–client relationships and the broker-customer relationships traditionally fostered on Wall Street were crucial conduits for the free flow of information necessary for the healthy functioning of free markets. When those relationships turned adversarial, the flow of market information became sclerotic and distorted. Inevitably, the financial markets as a whole ceased to function at optimal efficiency.

The financial crisis was fundamentally a crisis of ethics and values. Although we acknowledge the indispensable role of government and regulation, we believe that no amount of government regulation can succeed where the moral core is corrupt. Our emphasis on Wall Street Values comes from our belief that an essential component of the solution to the growing gap between the interests of the financial community and the interest of society must come from the private sector. Unless Wall Street itself formulates a coherent moral response to the crisis, no amount of regulatory oversight will prevent another, potentially more destabilizing, crisis from occurring. The sustainability of capital markets ultimately depends on the moral underpinnings of the people and institutions that drive financial markets.

Without a radical transformation of ethics and values in the financial community, the system as a whole is fundamentally unsustainable. It is thus in the interest of financial professionals themselves to support and lead their own moral instauration and a recasting of Wall Street Values.

Although as business ethicists we are hopeful that Wall Street will understand the need to consider questions about values and ethics, we believe that government also has an indispensible role in protecting the public interest. To borrow one of the more memorable concepts from the nuclear age, governments should "trust but verify" when it comes to markets. We appreciate the power of free markets to generate value that can benefit all of society, but we also believe governments must monitor financial markets to verify that they are indeed competitive and to enforce basic ground rules of information flow and other essentials of economic efficiency. The less effort Wall Street undertakes to clean up its own house, the more government will have to step in and do the job. The modern state, however, has limited power to protect the public interest, particularly in a technologically innovative context in which capital has become so large, so concentrated, and so global. At the end of the day, no amount of government regulation will keep us safe from future economic crises unless

Wall Street executives begin to think and act in a more socially responsible manner.

It is not an option to return to the halcyon days of mid-twentieth-century Wall Street when the industry and society prospered together. New ethical principles must emerge in the twenty-first century to sustain the integrity and social responsibility of complex modern financial institutions. How did Wall Street Values stray so far from a healthy and sustainable connection with the public interest? What Wall Street Values are required to sustain the financial industry and the economy in the twenty-first century? We believe that Wall Street, the City of London, Frankfurt, Tokyo, Shanghai, Dubai, Sao Paolo, and other global financial capitals must adhere to clear and strong ethical precepts for their own financial survival as well as for the benefit of our shared general welfare. Our hope is that this book will help motivate Wall Street to reinvigorate and reinvent its moral code, values, and expectations to bring them up to date with the new and complex business models that are evolving in the second decade of the twenty-first century.

Plan of the Book

We begin our analysis in Chapter two by setting forth a minimalist conception of corporate social responsibility advocated by the iconic economist and free market advocate Milton Friedman. According to this view, the sole social responsibility of business is to increase profits. We apply a minimalist social responsibility standard to the financial industry because Wall Street professionals universally espouse the libertarian, classical economic ethos on which this conception is built. However, we demonstrate that the modern financial industry fails even this minimal test of social responsibility. Moreover, when Wall Street is inefficient and the hard economic rules that underpin the minimalist conception are even temporarily nullified, the negative impacts on the economy can be dramatic. There is a rippling effect throughout the entire economy. Wall Street poses a threat to capitalism because it can distort the efficient allocation of capital and short-circuit the free flow of information vital to free markets. In particular, new businesses and ordinary workers are vulnerable. The long, deep, and socially destabilizing recession that has followed the 2008 financial crisis is a testament to the vulnerability of the economy to Wall Street's lack of market discipline.

In Chapter three, we describe the unintended consequences of government policies further severing the connection between Wall Street profits and free markets. The institutional seeds of the financial crisis came in the form of two massively misaligned and inconsistent ideological and regulatory sea changes in the financial system – an orgy of deregulation, mergers, and capital adventurism that created exponentially larger risks for taxpayers, coupled with a declining and ultimately irrelevant regulatory oversight of the financial markets. There was less and less government involvement until all at once there needed to be more government involvement than could ever before be even imagined. We describe how the post-Depression-era regulatory framework became outmoded in a brave new world of financial derivatives and other investment exotica. Policies implemented by the government dating back to the Clinton era opened the floodgates for massively scaled and risky markets, such as the mortgage-backed security market, eventually leading to the financial crisis. We also reflect on the lessons to be learned from the policy makers, regulators, and academics such as Brooksley Born and Elizabeth Warren that, in the pre-crisis era, expressed ominous, but neglected, warnings about the dangerous levels of systemic risk in the financial system.

In Chapter four, we describe the transformation in Wall Street's business model occurring over roughly the past three decades. We explain how the core values of financial firms shifted from rigorous adherence to customer orientation, trust, and mutuality to one of beggar thy neighbor, where firm profits came from, and often at the expense of, counterparties on the other side of the firm's most profitable transactions. Financial institutions evolved from a mix of customer-focused businesses to turbocharged engines of increasingly complex and abstract financial wealth creation. Perhaps the most obvious telltale sign of this transformation was the massive growth and increasing importance of precisely the kind of proprietary trading, particularly of CMOs and derivatives, that was at the center of the financial crisis. As the traditional customer became detached from Wall Street's traditional core business and values, a maze of derivatives, swaps, and complex financial instruments unimaginable to virtually all the brokers and investment bankers of the twentieth century emerged. We examine the economic and moral consequences when Wall Street firms operate in a manner that is detached from concerns about long-term relations with customers.

Chapter five gets to the heart of the transformation of Wall Street Values. In this chapter, we analyze the complex ethical dimensions of information asymmetry in the financial industry by considering various transactions by Wall Street's most successful, prestigious, and powerful firm in the pre-crisis era – Goldman Sachs. We consider, among other transactions, the infamous Abacus deal, which has become a transformational watershed of Wall Street Values. It was shocking for most people to learn that Goldman Sachs was deliberately packaging a financial instrument that would become worthless and, knowing that it would soon become worthless, was simultaneously selling this product to its customers. We argue that Goldman Sachs and other firms involved in similar transactions did not understand the ethical issues involved because the only values they understood were relevant to an earlier client-driven era, and no coherent principles and bright-line rules have yet emerged to address the ethical challenges of twenty-first-century Wall Street.

In Chapter six, we discuss Wall Street regulation in the twenty-first century. We analyze the central provisions of the Dodd-Frank Act as well as other global reforms. In particular we focus on the Volcker Rule prohibitions on proprietary trading by federally insured banks. We consider whether these measures adequately address the risks that we have identified that Wall Street firms pose to the flow of information in the capital markets and the allocation of capital in the economy.

The book concludes in Chapter seven by building on the work of earlier chapters and offering recommendations to right the ship and ensure the sustainability of financial markets. We propose some areas such as compensation policies and the management of conflict of interest where Wall Street might begin the conversation about business ethics. We argue that the financial crisis was fundamentally a crisis of values, and that unless Wall Street itself formulates a coherent moral response to the crisis, no amount of regulatory oversight will prevent another, potentially more destabilizing, crisis from occurring.