Anatomy of a financial collapse: Ethical, Managerial, and Governance Issues

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Abstract

The financial catastrophe that exploded a few years ago did widespread damage to the economic and financial systems of many countries, severely affecting GDP growth, lowering levels of employment, curtailing tax revenues, and, in some developed nations (such as the United States), driving many financial institutions to the brink of bankruptcy. Collapse of the housing market, rising foreclosure rates, and sharp drops in consumer spending added to the mounting challenges. While much of Europe was afflicted by the malaise, particularly because banks in the region had acquired securitized "toxic assets" and had also bought into the notion that the range of financial innovations developed and marketed by banks and other corporations was the key to the continued growth of developed economies. Much has been written about the origins and the domino-like sequence that led to the implosion, and the paper briefly reviews how the situation got so terribly and rapidly out of control.

In addressing the causes underlying what went wrong, the paper's initial focus is on ethical issues. While many individuals skirted the law, some actions (predatory lending, mingling of healthy and toxic assets, borrowers' moral hazard, etc) verged on the unethical. Top-level management's salary and incentives are set at astronomically high levels, purportedly since their talent has to be rewarded, a practice which continues whether corporate performance is outstanding or dismal. This questionable continues to this day in the United States. Again, institutional investors have often abdicated their responsibility in corporate governance, giving chief executives a free hand in running both financial institutions and firms heavily vested in the financial services industry. Managerial factors such a lack of diversity, and coercive leadership are discussed. Among the factors focused on are the role institutional investors play, whether investor activism can address some of the problems, methods to reform top executives' compensation, and the urgent need to refocus attention on innovation in the "real" economy, while achieving sustainable growth.

Financial tsunami

The tsunami that engulfed financial institutions and shook the economies, and even stability, of most nations, has already caused widespread damage. The potential for further damage remains high. Likening the crisis to a tsunami is particularly appropriate not only because of the large scale destruction of wealth, livelihood and even hope, but also because of the insidious nature of its arrival. The seismic measurements that mark the origins of a tsunami can be recorded but take place in the murky depths. The standing wave that follows appears to be no more than a ripple whose devastation is wreaked mainly on shore. Analogously, the increasing inability to meet mortgage payments , banks' double jeopardy as investment bankers and as purchasers of potentially toxic securities, the buying, selling, insuring, and rating of securitized instruments, which were "black boxes" of risk, all had within them the seeds of disaster. Even when signs of trouble began to surface in real-estate and in banking, few saw what the "standing wave" would do when its full fury was unleashed. Of course, there were many who

predicted trouble but apart from the few who now appear prescient in foreseeing the extent of the collapse, most consisted of the usual gaggle of capitalism skeptics, anti-globalists, and believers in a long term regression to the mean. Of course, all these and others who foresaw disaster had grains of truth in the doom they prophesied, but few could specify the multiple sources that would feed into the collapse. In this paper, we start by reviewing some of the short- and long-term repercussions of the financial tsunami which, at one point, wiped out over 70% of the capitalization of the world's major stock markets.

In a general sense, it may be argued that capitalism, particularly where financial markets and transactions were concerned, ran amok. Globalization and instant communication across the world meant that jolts, and even jitters, in leading markets, such as the United States (U.S.) had almost instantaneous worldwide repercussions. Both the stock and real estate market bubbles, moreover, were like hot air balloons connected to each other and, in turn, to instruments whose value depended on the two balloons riding ever higher, preferably unconstrained by regulations. This "Anglo Saxon" (The Economist, 2013(a)) version of capitalism has, accordingly, come under fire particularly from members of the European Union- France and Germany for instance- who contend that the laissez-faire attitude toward financial institutions across the channel and the Atlantic was the cause of the meltdown. At the G-20 meeting in early 2009 some European leaders expressed the view that since their continent was hardly exposed to the dangers facing the US, not only did they not have to implement corrective policies, fiscal and otherwise, the Anglo Saxon nations, in fact, needed to become more like their European counterparts. It is of course true that the bulk of the so called toxic assets, which, according to the IMF total more than $4 trillion worldwide (Financial Times, 2009), emanated in the US. However, the an estimate suggests (Parkercountyblog, 2011) that over a third of almost worthless instruments are held outside the US, mainly in, Europe with German banks accounting for a large portion of exposure. When profits appeared to be there for the taking, European banks did not want to be left behind.

It is by now obvious that the damage caused by the meltdown will linger for many years. The contraction in GDP, rise in unemployment, drying up of credit, shell shocked lenders, reduced public trust, and so on, have done severe damage to the system, in a sense, traumatizing the various players involved

Remedial actions and reactions

Among the actions being contemplated to protect a recurrence of the catastrophic events of the recent past are an increased regulation of hedge funds, empowering the Federal Reserve to track and moderate systemic risk, and the creation of an overreaching financial regulator, the Consumer Financial Protection Agency (Gravois, 2012). There are a bewildering multitude of financial instruments and hedging methods, some barely understood even by their own sponsors and industry experts and new ones are being invented all the time. Understanding and keeping up with ongoing developments are difficult enough, analogous to the uphill task of developing antibiotics to counter rapidly mutating bacteria. Regulating this constantly changing product could well prove to a Sisyphian endeavor. The position of an overarching "financial czar," though perhaps justifiable could prove to be equally tricky and an exercise in futility. Clearly, there were, and are a plethora of regulatory bodies charged with oversight of each of the activities in the chain of financial destruction. By one estimate, in the US, there

are multiple regulators of financial markets, federal banking, and state banking and insurance corporations. Borrowers, mortgage originators, loan servicers, mortgage-backed securities and collateralized debt issuers, insurers of such securities, and credit rating agencies, each had at least one regulatory agency monitoring their actions. Little has been heard or said about the "dogs that did not bark in the night" as Sherlock Holmes might have put it. One explanation might be to continue with the canine metaphor, that each watchdog agency was responsible for no more than a sliver of the entire spectrum of real estate, financial services governance, marketing, and other activities that played a part in the system-wide failure, and deferred to others to raise the alarm. Divided responsibility meant reduced accountability. For instance should the SEC have investigated AIG's backing of collateralized debt obligations (CDO's) or was it the responsibility of the insurance industry regulators, or both, neither, or of others? Should the Federal Trade Commission have become more aggressively involved in investigating sales techniques for sub-prime mortgages? Should bank regulators have investigated loans with low down- payments to people with poor credit ratings or was it the job of the Home loan regulators. Should the FDIC have cracked down on banks for risky lending or was it the Fed's job to ensure that banks did not exceed a safe multiple of deposit? And considering that the same banks were often making risky loans, securitizing them, and even investing in them, who should have been the regulator of record? Unless the question of why the existing regulators didn't do their jobs probably is addressed, all attempts to prevent a repeat will be little more than speculative. In this context, the appointment of an overarching regulator or czar might appear to be timely. However, unless the gaps in regulatory control and instances of falling between the cracks, and so on are addressed, and standard procedures devised for dealing with such gaps in regulation, "technical" claims asserted by regulatory agencies are likely to result in a recurrence of failures to act.

Whether markets- financial and otherwise – need to be regulated more or less is of course, a matter of context, history, and perhaps ideology. While much of Europe is comfortable with the notion of regulation to minimize the potential damage that could be wrought by unrestrained market forces (many of the formerly communist countries of Central and Eastern Europe are exceptions) the United States appears to fluctuate between Rooseveltian and Reaganite attitudes to state intervention in markets. Even during the most recent crisis, opinions varied widely among economists over the underlying causes and the short and long term remedies needed. On the one hand, we have experts such as Stiglitz (2008) and Bogle (2006) who argue that to prevent capitalism (and globalization in finance particularly) from running wild and wreaking havoc again, tougher regulation on risky investments, hedging strategies, and the movement of capital are needed. Enforcement agencies must be given powers to curb risky actions that jeopardize the financial stability of a range of stakeholders apart from the viability, and of the system itself. On the other hand, we have advocates of more laissez-faire in order to compensate for the disastrous developments of the recent past. The best strategy, it is argued, would be more of the same. Though this might appear to be equivalent to suggesting that the best cure for a hangover is to imbibe more, this line of reasoning draws strong support from many financial institutions and their lobbyists. Even if it meant the collapse of large financial institutions and jeopardize the viability of the system itself, from the ashes would rise a new, more vibrant system. It is also worth noting that financial engineering , that is the development and marketing of new derivatives and other esoteric products, has become a career path for a large number of bright graduates- in

business, engineering , the natural sciences, and from liberal arts as well- in the United States. It is unlikely that innovation in financial products will disappear completely. The attempts presently underway to regulate derivates might succeed in choking off overly risky strategies at the cost of creativity. In a manner of speaking, regulation might kill the geese that generated a hatchery of golden eggs. There is a likelihood that a generation of financial innovation spawned in the Wall Street of the late 20th and early 21st centuries might migrate to less restrictive environments in Honk Kong, Singapore, or even Shanghai or Bombay.(It is being reported that the Chinese government is undertaking actions to become host to the kinds of financial investment and innovation that has brought high returns accompanied by unexpected and contagious risk to firms in developed nations (The Economist, 2013(b)). Regulation should be minimal, according to this school but should be directed at curbing fraudulent behavior, not in eliminating or even limiting risk. In fact, investors ought to be free to make risky bets so long as they bear the consequences of their actions. The question of who bears the full brunt of risk-taking gone amok needs to be addressed, just as the operation of unsafe vehicles affects not only the company making the products and the driver, but also unknowing, innocent bystanders.

The EU advocates transnational regulations which would apply to the financial services industry and to all the instruments it creates. This would require the creation of a transnational financial industry " super-czar", with an administrative reach across products, firms, and nations. The US, with its history of safeguarding its sovereignty- in economic, political, militarily, social and other matters – opted, initially, to pump large amounts of funds into saving major institutions such as AIG and Citicorp, encouraging J.P. Morgan Chase to acquire Bear Stearns and facilitating Goldman Sachs transformation into a bank to avert an implosion of the financial system. Secondly, regulations have been developed to moderate risk, and the constrain actions that arise from a unwillingness or inability to better understand immediate and systemic risks. . While the pendulum of American public opinion and political sentiment appears to be swinging toward greater regulation of markets, a consensus appears to be building for taking incremental action, such as monitoring systemic risk, ensuring that the potential for creating more toxic assets is minimized, insurers have a fair idea of what they are backing, etc. The scope of regulation proposed is likely to be narrow and limited. The process of developing such regulations is likely to be evolutionary, and remain fluid for many years. It is also fraught with difficulties and uncertainties of its own.

The attempt to codify what hedge funds, for instance need to do in terms of informing the appropriate watch dog, obtaining approval, conducting due diligence, so to speak, suggesting product changes, and so on, are part of a complex process of arriving at a compromise. Negotiations and deals among firms in the industry and their lobbyists, government officials, members of congress, the Fed, existing regulatory bodies, shareholder groups, the buyers of US debt, and others will likely continue before bills are introduced and debated. There are, however, deficiencies that are likely to persist, and breakdowns which will probably recur, if the remedial actions pursued do not go beyond the cosmetic and marginal.

The concept of any entity being "too big to fail" is a case in point. As organizations such as banks, for instance, progressively expand the scope of their operations beyond accepting deposits and making loans, they increase both their earnings potential and the number of ways in which they could lose

money. Making matters worse is the likelihood that losses in one area could affect the performance of other products. This cascading effect makes the entire, interconnected system vulnerable and needs regulatory firewalls if the snowballing of risk, which places the entire financial system in jeopardy, and makes society the prime guarantor, is to be prevented (Admati and Hellwig, 2013).

Ethics and the changing face of banking

One of the distinguishing features of modern banking is its radical transformation from an institution accepting deposits on which interest at a certain rate is paid, while lending at a higher rate to generate profits. Banks today have, by and large, expanded their scope far beyond the basic operational model. Depository transactions remain, but constitute a miniscule-and shrinking-source of funding for loans and other assets they acquire. Banks now borrow extensively (and mainly short-term) to finance their ongoing operations. For instance, the purchase of securitized mortgage products and other assets (including collateralized debt obligations, or CDOs, and hedge funds) has often been, and continues to be, accomplished with the help of debt. While deposits up to a certain fixed amount are insured and guaranteed in certain countries, banks often invest depositors' and borrowed funds on risky bets. The mingling of deposits with other funds clearly places deposit guarantors in the invidious position of paying for banks' mistakes. Placing a firewall between deposits and other activities (the so-called Volcker Rule), might ameliorate this particular risk, making for greater probity and ethical behavior. However, the strong resistance expressed by bankers and their lobbyists to proposals of this nature, is a clear sign that banks do not see any moral objections to risking depositors' and taxpayers' (for the deposit insurance) money on innovative and inherently risky products (Politico, 2012). Given the power wielded by banks in society, passing and enforcing regulatory limitations on what may be invested and where are likely to be uphill tasks (Sanghoee, 2012). Considerations of ethics are not likely to weigh too heavily with a powerful industry, imbued with a sense of its own indispensability, which pursues short term gains, using funds from all possible sources to invest in activities whose downside risk falls on society as a whole. The fact that top executives stand to make fortunes from successful investments, which they retain even if the financial system later collapses, taking the national (and maybe the world) economy with it only makes the need to address the ethical dimensions of banking even more critical.

Calomiris and Huberl (2013) note that American banking evolved from a fragmented industry over which a landed merchant class held sway, to one dominated by large consolidated banks owing allegiance to the urban wealthy. The prevalent banking "bargain" in certain countries may have well have evoleved in different ways in the countries the authors compare in their paper (the U.S. vs. Canada; England vs. Scotland), but it does not follow that the policies and regulations in place cannot be modified. Any changes would also take much debate and time to agree upon, a face not made any easier by the powerful lobbies and other advocates for the financial industry.

One action that might somewhat alleviate first-level risk could be increasing the equity as a percentage of the total assets held by a bank. Increasing this amount from around 2 to 5% which is common today, to around 10% would provide a solid backstop to a potential panic engendered by an inability to pay off short term debts due to an investment (or bet) going sour. Such an equity base would reduce item-wise, firm level, and portfolio risks. The interconnectedness of (a) financial products and of the (b) short term lenders with banks, (c) loans to borrowed funds, (d) banks creditors to one another,

and so forth, make the entire system fragile. The availability of more shareholder investment would obviate the need for such high (and panic-prone) leveraging. Of course, more debt multiplies the return on equity (ROE), but magnifies the downside risk. Ironically, banks seem willing to borrow money to fund their investments in esoteric, often dubious financially-engineered products, but seem to have little appetite for innovative products and services that people can actually use. One might argue that, in a free-market system, banks, like other businesses, should be free to pursue the courses of action they deem most likely to result in the highest profits. While true in concept, the realities of mammoth size, interconnections and systemic fragility, mingling of deposits (guaranteed ones in particular), and high leverage needed to fund often risky assets, the low level of equity, and so on, makes the imposition of higher standards on the banking system all the more imperative. Raising more equity, reduced short term borrowing for investing in new products, stricter reviewing of debt packaged as securities and so on, are not only more prudent financial actions, but are, in fact, moral choices, since clients do not have the same options as they would in a free market. In the latter case, if the product proved to be unsafe, one could stop purchasing it, thus putting the firm out of business. In the case of financial products, often even the innovating firm and its CEO are (or can claim to be) unaware of all the risks involved. More caution and back up resources would be then be both judicious and ethical. Of course, individuals need to exercise some discretion as investors, depositors, borrowers, shareholders, and so on. Regardless of which stakeholder role(s) one plays, the pursuit of ever-greater short term gains, even at high levels of risk only stimulate more risky behaviors on the part of the executives of financial institutions. As has been asserted by some authors, "too big to fail" is a result of "too big NOT to fail" (Admati and Hellwig, 2013), and the rapid growth in size and scope of banking institutions arises from, at least in part, the widespread support from various stakeholders. For instance, the explosion in mortgages started with a buyer and seller, both of whom failed to exercise good judgment (evaluating one's ability to pay, assessing creditor worthiness). Mortgage lenders who sold their loan to companies which packaged them in branches, sold them as securities, the rating agencies, the investment banks who then resold them, the list goes on, each player in the chain of financial irresponsibility did not, at the very least, do their due diligence. The most likely explanation is that normal procedures were not followed because they would have restrained financial growth and profits. The series of decisions not to exercise proper oversight constituted a massive failure of *morality*, a case of *collusion* in unethical behavior. Over three decades of an enhanced emphasis on ethical training and a focus on grounding management in moral decision- making has apparently achieved little, if any, traction. The overweening focus on short-term performance (particularly in Angelo-Saxon societies) blinds many to the long-term damage that can result when the unexpected happens in one (perhaps minor) part of an interconnected financial grid. As in an electrical grid, if there are no safeguards, failures could cascade through the entire system. The obsession with alpha (above average returns) could make a mockery of managing firm and portfolio-risk, when systemic risk could potentially be high, and can have catastrophic effects.

With good reason, financial collapse and climate changes are viewed as the two most serious threats facing humanity, calling for actions to ensure sustainability in both areas. Ecological and social issues are typically considered in planning sustainable strategies (Admati and Hellwig, 2013). However, given the pervasive and powerful role financial institutions occupy in modern societies, the continued viability of these institutions is critical to ensure that future generations are not placed in serious jeopardy. It is

indeed ironic that economists and politicians who are deeply concerned about the national debt and advocate measures ignore two existential threats- the financial system and climate change. In fact, these two complex phenomena may well be linked to each other. Experts now argue that financial systems, subject as they are to their own sources of fragility and instability, are likely to be increasingly prone to even more systemic risk caused by external perturbations in the years ahead. It is all more essential therefore that ethical and other approaches be brought to play in dealing with financial risks themselves (Eccles and Serafeim, 2013). We now address the managerial and governance actions that might be usefully deployed.

Financial institutions and governance

A central challenge lies in the roles that most individuals in modern industrial societies play or, equally importantly, fail to play, and the differing expectations we have in each role. As shareholders, we expect the companies in which we own stock to make money. Whether they make money making better products or by getting into the derivatives market typically doesn't matter to the average investor. Shareholders rarely delve into the strategic directions and plans pursued by the firms they hold equity in. All is well so long as the stock price keeps rising and dividends are paid. The bulk of shares traded in the U.S. are owned by institutions and most individual owners of shares take little interest in the decisions that fund managers make (Bogle, 2006). Few shareholders bother with such facts as the returns from most funds being lower than that of the S&P 500 or that the rising costs of fund management erode investors earnings. In our role as employees of product/service firms in the real economy, we might prefer that companies invested in more value creation by investing in themselves, and less in financially engineered products which lead to the outflow of funds

Top executives, often rewarded for short term success, pursue all avenues to maximize the returns from their stock options and short term successes. CEOs of firms are handsomely rewarded when things go well, and when results are poor and they are let go, typicallywith severance packages a few hundred, even thousand, times what the general run of employees would get. Since their salaries are, in general, around several hundred times the average worker's wages (sometimes of the order of 1500 to 1 (Bloomberg, 2013), such generous rewards for failure appear even more outrageous.

When it comes to financial institutions, including banks, we have little objection to their dabbling in a range of activities- mortgages, investment and commercial banking, insurance, hedge funds, and so on – based on the premise that more is always better.

In a sense, as investors, we expect corporations (including financial institutions) to act in ways that would maximize returns. However, as investors, most of us are unaware - or do not wish to know – of the escalating risk as the scope of companies' forays into diverse fields widens. Of course, all this matters very little when investors are raking in the cash or even when losses are incurred so long as these are confined to those who make the faulty investments in the first place. That is, if the downside to poor investments is a sort of "neutron bomb" in terms of fallout.

Confined to a limited area, most people would say that such an outcome would be fair and in keeping with anyone's notion of free enterprise. However what we now have is a system in which failure in one part of a large organization(e.g. in insurance claims) could have a domino effect on the rest of the organization (real estate, hedge funds, etc..) and, indeed, on other firms as well as on the system itself. The insidious spread of "toxic" assets whose value is so difficult to estimate (the IMF puts it at over $4 trillion), arises in large part from the extreme interconnectedness within and between financial organizations. Risk-takers and risk-bearers are inextricably bound together, and culpability is almost impossible to assign, particularly considering the varying motivations of the major players. Worse, such toxic assets are almost impossible to locate until one starts digging for them. This sort of "financial archeology" is rarely undertaken until things start going wrong, by which time toxicity is likely to have spread insidiously, sapping organizations financially and in spirit. As the burgeoning scope of operations of large firms results in financial empires networked globally, they create firms that are opaque in exposure levels and are inherently "too big to fail", as well as because there are other, as yet perhaps unknown, dominos that would also tumble .

In essence, then, we are now faced with various types and levels of moral hazard. As individuals put their money in diverse types of instruments under the impression that they are diversifying risk, they may, in fact be multiplying it. We may be willing to accept the premise that we are responsible for our investment decisions, but we tend to balk when we are faced with the prospect of losing everything we have in supposedly diverse investments. We expect to be rescued. We switch from accepting individual responsibility to expecting societal responsibility. Rather than our individual assets being placed in jeopardy, the taxpayer and the national budget bear the brunt of millions of decisions gone awry. Large financial institutions, by diversifying into new products and markets, have similarly grown so large that their failure is likely to bring the entire system to its knees. "Too big to fail" is a blithe and blatant expression of moral hazard consciously or unconsciously embraced by firms such as AIG, Citicorp, and Bank of America, and compliantly accepted by the regulators. Claiming that a firm had grown so rapidly that it was difficult to evaluate and monitor all its disparate operations merely adds incompetence to moral hazard. The financial strategies adopted by non-financial firms as a means to bolster the bottom line is often justified on the grounds that firms need to do everything possible to meet the earnings targets if they are to maintain stock prices at an acceptable level. Accounting sleights-of hand, and investments in derivatives though adding little substantive value, are imperative to sustain the bottom line and keep up with firms vying for the same capital. The unwillingness to break ranks with their peers is at the very least, an act of moral cowardice. Few companies take the "high road" of relying on their strategic capabilities in their chosen products /markets/ technologies in order to achieve success. By taking the path of least resistance, even if it does not help in building a sustainable competitive advantage, corporate leaders abdicate their long term responsibilities to their stakeholders including shareholders.

Top executives, in preferring smoke and mirrors over making money through innovations in products and services, creating and nurturing customers, building networks with other firms, and so on, appear to lack the moral fiber to make the tough decisions that might cost them their jobs. And why should corporate leaders care? After all they are rewarded for immediate results, often with generous stock options, inducing decision – makers to maximize stock prices long enough for them to cash in. Rewards

offered to top executives, apart from high salaries, include lavish separation benefits such as golden parachutes, free apartments, pensions, and so on. Not only are corporate leaders rewarded for myopic management, there are generally few restraints on their actions. For instance, in most American firms the positions of chief executive officer (CEO) and chairman/chairwoman of the board of directors are combined (Edfelt, 2010). Reviews of corporate performance by the board are often formalities with the same person being in charge of decision-making and outcome-tracking. The CEO as Chair has the discretionary power to appoint executive members to the board. The likelihood of such an appointee disagreeing with or opposing the strategies or assessments made by the CEO/Chair are clearly remote, often making the Board little more than a rubberstamp for corporate leadership. One could argue that the mutually reinforcing nature of the relationship between the board and top executives points to obvious flaws in corporate governance. While that is certainly true, it is equally valid to claim that it is further evidence of the ethical corrosion that has occurred in the financial system and in the way companies are managed. Though some reforms have been instituted (in part as a result of the Sarbanes Oxley Act), such as the constitution of an autonomous compensation committee, and the requirement that the financial statements must be certified by the board, the impression that the system is geared to benefit the upper echelons of corporations, financial and otherwise, is widespread and justified. Many scholars suggest that the economic system may best be described as corporate capitalism since the landscape is dominated by large corporations and the decisions their managers make. Some refer to it as corporate or managerial capitalism (McCraw, 1997) given that governmental policies are typically directed to benefit companies. The pattern of tax cuts enacted since the 1980's reinforces the image of a system that favors corporations and their top decision-makers. In that sense, a more appropriate label might be executive capitalism, particularly since the majority of the managerial cadres of most companies are judged by the yardstick of corporate performance. Top executives on the other hand, stand to make major fortunes if their firm does well and minor fortunes even if it does not. As the financial value of banks, other financial institutions, and other large firms rides high (on the books, at least), the leaders of these corporations rake in the cash. Most people feel these titans deserve their wealth since they were in charge. However, when firms, industries and, perhaps a large part of the system starts going down, these same executives keep their wealth which is then augmented by separation benefits- the rewards of failure. "Trickle down" is a misnomer. The form of capitalism nurtured in the United States is better termed "trickle away" capitalism. That's what seems to happen to much of the wealth created in the upswings. It trickles away from the employee, investor and citizen when things start going sour (Phillips, 2002).

Making matters worse is the fact that nearly 70% of all shares traded in the U-S are held by institutions in mutual and equity funds. In a sense, therefore, though over 50% of the American public owns stocks, intermediaries (such as mutual/pension fund managers) exercise the decisions of ownership (Bogle, 2006). The power to get directors elected and to monitor/change the directions firms adopt is well within the power of these powerful shareholders. However the available evidence suggests that institutional fund managers have all but abdicated their responsibilities. Typically, they do not play an active part on board of directors or attempt to hold companies leaders to account, except by way of dumping shares of the firms in which they have lost faith. By voting with their feet, in a manner of speaking, fund managers, no doubt, act in the best interests of their clients. But by pulling money out in

large amounts when companies fail to meet certain preset markers, such as earnings targets, institutional investors often wait too long, selling after the lack of results is apparent. Moreover, they hardly do either investors or corporations in which they invest a service by waiting to act only when *outcomes* are unsatisfactory. A lack of participation in the *process* of managing corporate affairs works to the detriment of investors and corporations alike. Turnover in stocks which was a bare 15% four decades ago stands at over six times that rate now, meaning that stocks turnover, on average, about once a year now. In effect, we might say that the system is one of stock-trading rather than ownership. The irony is that, outside the country, American capitalism is deemed to be shareholder-driven and not sensitive to the needs of diverse stakeholders. The age of investor involvement in corporate strategy is long gone. Fund managers adopt a reactive stance, divesting shares when the signs of trouble in a company are all-too-serious.

There is of course, the well-known agency problem in corporate management where the interests of the principals (i.e. shareholders) may be subverted by the managers attempting to maximize their returns not only in short term stock options and bonuses, but also more intangible outcomes such as more power, a reputation for daring actions, and so forth. The second agency problem arises in fund management companies where shareholders interests are subject to fund managers' predilections which, as we have seen, lean toward minimum involvement in the companies attracting their investment. The shareholder in the U.S., then, owns vast amounts of property whose care is entrusted to stewards whose interests lie elsewhere. The failure, indeed unwillingness, of those entrusted with responsibility to act on behalf of their constituents makes for a deep rooted ethical crisis. There is little doubt that so long as a culture of power-without-responsibility prevails in the higher echelons of corporate and financial America, attempts to reform the system will be futile.

The several failures that have come to haunt our financial institutions have, on occasion, been attributed to a lack of understanding of the complexities involved or due to the failure of others to uphold their end of the bargain. Here too, there appears to be a moral breakdown. For AIG executives, say, to claim they did not fully know the toxicity of the securities they were issuing appears to be disingenuous. Perhaps it would be more accurate to say they did not care. Undoubtedly AIG executives have lost much due to the collapse of the financial system but, being "too big to fail", they have been propped up by the government. Some executives lost their bonuses, but none returned the bonuses they received in the past, while the poor shareholder has had to forgo any gains made during the same period, and is, in fact, left with next to nothing. For AIG, Citi, or Bank of America to say that those whom they did business with did not do their due diligence or even broke their word is equally disturbing. The first guiding principle for such firms is prudence, which would dictate they do not leverage themselves to thirty or more times their equity. For banks to make loans to home buyers, with little if any down payment and with monthly dues obviously beyond their ability to repay, was downright irresponsible. Equally feckless was the behavior of investment bankers who purchased worthless assets on trust bordering on indifference. Greed has been blamed for some of the rash decisions made by bankers and hedge fund managers, and it probably played a central role in the unraveling of a system built on the hope of an unending accretion of wealth However, at least as much to blame was the implicitly accepted code that all the players would share in payoffs, the gains being distributed hierarchically , however, with an exponential decline from the decision-makers on down. The losses, however, are

shared in the reverse order, the highest losses relative to total assets owned being at the lowest levels (the individual investor). The burden of moral responsibility for poor performance in corporate governance, for poor investment decisions by fund managers and, in general, for, the decayed ethic of financial capitalism is not exclusive to those in positions of authority. Moral hazard is obviously at play, for instance, among the ranks of mortgage borrowers who willingly, and often willfully, took on more debt than they could handle. Those who subsequently defaulted on payments and trashed their foreclosed homes went beyond unethical to criminal behavior. As depositors, aware that our money is protected up to a certain amount helps to reassure us that, no matter how poorly banks invest our money, we are guaranteed, to get this amount back. We encourage banks to lend and invest more because we do not bear the entire risk. Again, as owners of shares, we take little interest in the companies in which we hold a stake, except to follow the prices of stocks. We do not make much of an effort to influence fund managers investment decisions or to induce them to reduce expenses. As shareholders and borrowers we tend to play the system not realizing that it is weighted heavily against us. Perhaps we do not care since the system as a whole cannot be allowed to fail. Little wonder that citizens and tax payers have to foot the bill which we as investors, shareholders, executives, equity, pension, and hedge fund managers, and so on have run up. One of the suggestions floated to address the problem of "director-capture" by corporate executives or the denial of accurate information to outside directors, is the implementation of network governance. In this system, directors not only occupy a position on the Board, they may also post their representatives at various levels of the organization to serve as their eyes and ears giving them a more ground-level view of corporate processes and behaviors (Turnbull and Pirson, 2012). Network governance would presuppose a high degree of concern and involvement on the part of the Board, a phenomenon that has been conspicuous by its absence in the bulk of financial institutions…so long as everything is progressing smoothly.

Management of financial institutions

The moral challenge posed by numerous actors each expecting the other to act responsibly is reminiscent of the Abilene paradox , often used by management scholars to illustrate aspects of compliance in group behavior. A phenomenon sometimes observed in groups is that when an unpopular idea is mooted particularly by a person in a position of authority or possessing specialist knowledge, people tend to go along with the suggestion even if many disagree, because the latter feel they might be the only objectors and would prefer to take the path of least resistance. (In the original formulation, the common project was a trip to Abilene which all, except the person proposing the journey, were opposed to making) In the context of the financial system though the many players do not defer to one another, they tend not to question what the other participants are doing. In a sense, then, there is widespread acquiescence in a system over whose disparate activities the various players have little oversight, intent and control, even though they know that a malfunction at any point in the system could seriously affect all the participants. This phenomenon is similar to groupthink except that in the latter case, differences of opinion may be aired and, later suppressed with a view to "going along" with others, not rocking the boat, etc. In "Abilene" organizations, on the other hand, silent deference is the norm perhaps because rigid, top-down style of.leadership. Combined with the implicit acquiescence of the Abilene paradox is the overreaching complacency and hubris of the Icarus Paradox, (named after the legendary son of Dedalus, the master builder of Greek mythology), who, with his wax wings flew too near the sun. The

Icarus Paradox is now applied to firms whose competitive advantage, which once made them eminently successful, could prove to be a source of failure if they rest on their laurels, or keep pursuing past successful strategies, even as expectations and environments change. Firms such as General motors, Kodak, Smith Corona (typewriters), and many others, have to varying degrees and at different times fallen prey to this pervasive sense of complacency. So it appears to have been with most financial institutions, their institutional investors, regulators, executives and boards of directors, and the people at large. As risk after increased risk paid off, it only spurred decision-makers to go farther and higher. The Abilene and Icarus combination created a system characterized by a constant ratcheting up of risk based on past success relatively unhampered by constraints imposed from the outside or internally.

As many authors have noted, the implosion(or imminent collapse) of numerous financial institutions and even entire economies in 2007/2008 does not seem to have any significant impact on the dominant ethos of pursuing the El Dorado of astronomical short-term profits by taking on unknown types and levels of risk. Rather than going through a period of reflection and reformulation of strategy as organizations which have gone through a near-death experience are expected to do, financial institutions seem to be doubling down on the same dangerous strategies and, worse still, actively delaying or subverting any proposed regulations. As Admati and Hellwig(2013) note, the reflex reaction of most banks to any form of regulation is that it would increase costs. However, the costs they are referring to are their own, failing to mention that the costs to society (in light of the domino-like world financial system) and economies globally, if regulations are not enacted and enforced, could be even more catastrophic than the last time around, constituting even an existential threat. Given the few curbs that have been enacted and the glacial pace at which regulation is likely to proceed (greatly hampered, one might add, by the need to achieve agreement across various nations and regional organizations), change from within, however, gradually it might occur, needs to be investigated.

One of the deficiencies in the operation of the financial and economic systems is their relatively low degree of diversity. By this, we do not only mean that minorities, women, gays and other groups are underrepresented. We refer here to cognitive diversity or differences in perception and thought process. If everyone in the upper levels of an organization possesses an MBA in finance, they are much more likely to see opportunities and risks that vary little if at all, from one another. Popular accounts such as those by Lewis (2010) attest to the development of this cognitive homogeneity. Including psychologists, historians, anthropologists, political scientists, and experts from other fields might facilitate the considerations of ideas and actions that would otherwise not arise or attract much attention. The use of anthropologists by product design companies, in order to incorporate cultural preferences and trends, is a pointer in this direction. The inclusion of ethnic minorities and women, leaving aside the question of equity, would also serve to bring a variety of cognitive process and attitudes to bear. Homogeneity creates a herd mentality and an often unconscious tendency to groupthink, both being outgrowths of the Abilene syndrome, exacerbated by the reluctance most employees feel of speaking truth to power. Companies such as Nike, Corning, Unilever, and Siemens value diversity partly because it affords them a multidimensional perspective on stakeholder preferences. The almost exclusive focus on maximizing shareholder value could blind firms to long-term issues, including the need to keep customers/clients, creditors, employees, and others satisfied. In financial services, the maximizing of shareholder value is pursued with even greater intensity because

rewards of top executives are often linked to return on equity (ROE), typically over the short term. In banks, this is particularly anomalous if equity is around 5% of total capital (which is often the case). In this case, making the needs of shareholders paramount appears to be self-serving, and little more than a front to justify the achievement of high ROEs regardless of the cost, to enable top executives to earn the lavish bonuses to which they have become accustomed. The need to pay attention to the needs and expectations of a wide range of stakeholders, which would also help to put risk-taking in proper perspective, is often given short shrift, since it detracts from income maximization among the topmost echelons of management.

The highly centralized structure of large financial corporations allows for little, if any, dissent. Even if greater diversity were to be incorporated in financial institutions, other supporting elements are needed in order to realize the most beneficial outcomes from "the wisdom of crowds", as Surowiecki(2005) puts it in his eponymous book. The author contends that, in diverse groups all the members need not be experts. In fact, he cites instance of groups in which individuals with little if any, specialization were leading contributors to group performance. Not only were they able to ask questions that threw new light on complex, murky situations, but they were able to suggest novel solutions as well. However, as the author notes, fresh perspectives and innovative suggestions will come to nought if they are not heard, accepted and acted upon. That is, diversity can bring a wide range of ideas to bear in financial and, indeed, other forms of, entrepreneurship if it is also accompanied by decentralization. The efficient markets hypothesis (EMH), which asserts that the market always prices a financial asset correctly and if more information emerges, the price adjusts accordingly, is assumed to hold not just for stocks but, and this is obviously a gigantic leap of faith, to an increasingly intricate panoply of derivatives. The apparent wildly inaccurate pricing of derivatives such as credit default swaps suggests that the analytical, quantitative approach needs to be supplemented. The involvement of a wider range of experts and non-experts, providing independent assessments (which may be based upon intuition, heuristics, experience, a deeper understanding of human behavior, etc.) is all the more critical.

The real value of cognitive diversity lies not in merely having it, but in putting it to good use. The knowledge gathered is then reflected in the wisdom of the decision made and implemented. However, since empowered lower level employees may well make decisions without considering their impact on other activities, groups, and institutions, a balance needs to be struck between centralization and delegation to arrive at decisions amalgamating diverse, disparate ideas, particularly in institutions facing complex and dynamic conditions,. To get the most mileage out of diversity and centralization, independence is the third criterion that enables large groups to exercise wisdom in making complex decisions. As a rule, most financial institutions are extremely hierarchic, though employees with the required expertise are typically given some leeway to engineer products which have to meet criteria regarding returns, risks, potential for growth, etc. by their superiors. However, even if consultation takes place, it occurs in a top-down configuration among people with similar view points and backgrounds, often resulting in a "information cascade", or a self-reinforcing set of ideas. The notion of "social proofing" or following what others are doing, adds to the tendency to reach reassuring, through possibly erroneous consensus. As Surowiecki notes, social proofing occurs when we assume that others know what they are doing, and decide to go along with them. It differs from groupthink in that social proofing

constitutes a conscious decision to imitate. The LIBOR scandal is a an instance of social proofing rampant on a widespread scale over an extended period of time.

With the increasing sophistication of financial instruments, the number of people who understand their workings shrinks to a handful. The impression that only experts can fathom and implement them tends to become widespread and compelling. Cognitive diversity and independence are rare, and leaving important decisions to employees and, perhaps, their supervisors, lacking complete knowledge of their systematic impact becomes downright dangerous. The problems caused by such a system are exacerbated when the overall milieu is one where regulators are constrained, or even coerced, to adopt a hands-off position. When regulators abdicate their responsibility to consultants, as is often the case, the potential for mayhem is far greater (New York Times, 2013).

It might be argued that the emergence of "lone wolves"(such as the London Whale) speak to the high degree of freedom subordinates enjoy to embark on projects without the approval, or even knowledge, of their superiors. However, the more likely explanation is that the coercive style of leadership characteristic of financial institutions, the pressure to deliver results in the short-term, the complexity of the products involved, and the desire not to know on the part of bosses ("plausible deniability") combine to give birth to "heroes" bringing in mammoth profits or "villains" leading the firm to take as large a hit when things go sour. A culture of enabling, even facilitating, unethical behavior provides fertile ground for bet-your-company type risk-taking. The case of Howie Rubin's $250 million loss at Merrill Lynch in 1987 provides one of the earlier instances of the trading of complex products gone wrong (Lewis, 1987). Rubin created a novel product by splitting bonds into Interest Only (IO) and Principal Only (PO) slices. Having sold the IO part, he was looking to unload the PO portion worth $500 million but, unfortunately for him, the bond market collapsed before he could find a buyer. Though it was claimed that no-one else at Merrill knew about the transactions, the most-accepted (and best case scenario) is that his bosses knew what he was up to, but did not understand the product and were perfectly amenable so long as it made money for them. Interestingly, Salomon made a similar bet and tried undercutting Rubin by holding on to the bonds. The IO proved lucrative but the PO chunk took a beating. The canny trader who made the PO buys managed to consolidate the IO/PO deal, thus masking his risky action, much to the frustration of the team holding the IO (most of whom left in disgust).

Birkinshaw(2010) makes the astute observation that the focus on "leadership"and the concomitant devaluation of "management" has contributed to the ongoing erosion in corporate standards, decision-making processes, and behavior in general. The increased emphasis on leadership in its visionary and influence-exerting roles, and the reduced importance accorded to more down-to-earth activities such as detailed planning, resource allocation, nurturing employees, monitoring subordinates' activities, intra-organizational communication, and so on, have resulted typically in highly stratified corporate milieus. Top executives tend to have little empathy or even contact with mid-level executives, not to mention the rank and file. The fact that CEO to first-level employee salary ratios have reach several hundred to one just makes the insulation of top executives from everyone else even more complete.

Conclusion

If the financial services industry and its supporting cast of experts in macroeconomics may be likened to a chorus, all singing from the same score, there are others, playing different roles in finance as well as in society at large, who seemed to join in without missing a beat. Journalists, who are expected to serve as watchdogs, were as mute as the official guardians (e.g. regulatory agencies). In fact, journalists (like regulators) often joined in the frenzy encouraging investors to buy under the assumptions that the markets would keep rising indefinitely. Occasional warnings were issued by noted publications such as the Wall Street Journal, and the Economist. However, these words of caution typically got lost in the avalanche of optimism, greed and anti-regulatory fervor. Moreover, most of the warnings were couched in rather general terms, and did not carry a specific timeline. Also carried along on the same tide of exuberance were politicians of all persuasions. Few wanted to propose reining in banks, real estate firms, hedge funds, and investors in the (then unlikely) event that the whole edifice would come crashing down. In conditions where the very perception of danger is dangerous, and could result in an information cascade, few wanted to be harbingers of doom. The few that tried were quickly silenced by others who had too much at stake to allow such silly predictions to gain ground. Moreover, as prospect theory would suggest, most individual and institutions were willing to accept potential losses in the long term provided they could make money here and now.

The question of whether Anglo Saxon (AS) European, Asian, or some other form of capitalism works best is, as we mentioned earlier, being actively discussed. By and large, the prevailing opinion seems to be that the AS model has been shown to be deficient and even downright disastrous. It is true, of course that much of the toxicity in financial assets originated in mortgage loans made and securitization carved out in the United States. Much of the process of financial engineering slipped under the "regulatory radar", met with the approval of numerous experts in macroeconomics and financial economics, was popular with shareholders, and so on. It might appear that one needs to address loopholes that have become obvious in the mortgage loan industry, clamp down on the hedging products offered, limit systemic risk, and so on, to prevent a repeat of the collapse of 2008. As evidence that such a tight monitoring regime would be effective, one might point to countries like China and India, which have, to some degree insulated themselves from the turmoil that has rocked financial intuitions elsewhere. By picking and choosing what they will permit, these countries appear to have found a magic formula for financial stability. But the growth of Asian economies has been inextricably tied to investments, technologies, and instruments from abroad. If China and India become more consumption-driven, they might well have to develop innovations (including financial) to sustain or accelerate economic growth. It is true that, as Santayana famously wrote, those who fail to learn the lessons of history are condemned to repeat them. However, it is probably equally true that those who learn the wrong lessons are condemned to make other mistakes that could prove as disastrous. Concluding that the origins of the crisis facing financial institutions and economies worldwide lie in a lack of sufficient regulation, or with any one segment of industry, would be a clear indicator that we have not learnt the right lessons. We argue that in order to avert a repeat financial meltdown, a mix of strategies and approaches needs to be adopted. Combining regulation (national and transnational), promoting ethical awareness and actions based on values(avoiding moral hazard and the search for plausible deniability), the incorporation of diversity, judicious decentralization, and cautious independence in decisions in financial institutions,

incorporating checks and balances in corporate governance, bringing greater pressure on fund managers to hold corporations to account, and achieving balance of product/service and financial innovation, and so on, need to be implemented, the appropriate amalgam depending on a particular society's context and needs. Not only are world economic stability and the potential for sustainable growth (without impacting climate) at stake. Spending on infrastructure upgrading, investments in science and technology to create the industries of the future, defense spending, funding for education, and so on, are likely to be ephemeral, and in permanent jeopardy, if the financial system can implode at any time . Not only has financial engineering taken to its risky extremes brought devastation to the economies of much of the developed world it has also succeeded in attracting to itself the best minds especially in the United States. Innovation in areas such as nanotechnology and biotechnology for over a decade have held out the promise of rolling out products that would transform our lives. However, the changes in these industries continues to be incremental (rather than occurring in radical jumps) and is likely to continue along the same trajectory unless a revolutionary change takes place in corporate strategic thinking. In the 1980's for instance about 15% of corporate profits were derived from financial services, growing to 25% in the 1990's and reaching over 40% ten years later. Why would the icons of American business such as GE, P&G, Xerox, and others not turn to financial innovation if it brought lucrative returns without the heavy investments needed to develop and successfully market new products? Of course companies need to innovate to keep growing. After all, the basis of competitive advantage in global markets lied in the ability to leverage innovation , reap economies of scale, enable knowledge development and exchange, and build a sustainable flow of new technologies base on supportive management systems. However, if there is more money to be made in short term investments and in hedging transactions, companies are naturally reluctant to pass up the opportunity. Even more, when the performance of every publicly traded firm is judged by its quarterly returns and whether it met its earnings target, we have a scenario in which the here-and-now, and investments with high potential earnings , even if risky, seem imperative.

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