Much has been said and written about the so-called “Sub-Prime” crisis of 2008 that, in one way or another, is still gripping the world. Understanding the intricacies of and considering appropriate responses to this financial crisis hinges on recognizing the complexity of the crisis and its causes and on acknowledging that those involved are not limited to the men and women who work directly in the financial services industry but include individuals from a broad spectrum of society. Careful consideration of the crisis, its causes and complexity provide an opportunity to engage students in a rich and multifaceted discussion of and response to the crisis. Though the target audience for this article is those teaching economics, finance, or other business disciplines, the issues raised are, or should be, of concern to others, since the impact of both the consequences—intended or unintended—of the crisis and the responses to the crisis are wide ranging within and beyond the United States.

For many years now, much attention has been placed on the need to include ethics in business education. In particular, AACSB’s Ethics Education Task Force urges business schools to encourage students to develop a deep understanding of the myriad challenges surrounding corporate responsibility and corporate governance; provide them with tools for recognizing and responding to ethical issues, both personally and organizationally; and engage them at an individual level through analyses of both positive and negative examples of everyday conduct in business.2

Engaging students in a careful examination of the causes and ethical dimensions of the financial crisis can assist in furthering these learning goals. As the article makes clear, the crisis was a long time in the making and involved many different parties. This realization can lead to two
Daniel Wueste provides a framework for undertaking such a discussion. Students can be asked to consider the article in light of Wueste’s discussion on unwelcome, unintended consequences, both foreseeable and unforeseeable. For example, which of the many shifts and changes, whether in services such as the introduction of the Certificate of Deposit or in regulations such as those that governed branch banking, can be categorized as resulting in unintended consequences? Does it make a difference if such unintended consequences are foreseeable or unforeseeable? Discussions about responsibility can consider questions of causality, liability, and capacity. As Wueste notes, this approach to the concept of responsibility is familiar to most of us. However his discussion of role responsibility provides a way of challenging students to move beyond apportioning blame for the crisis. Wueste notes that “the most salient feature of role responsibility is the way that it looks to the future rather than the past... it is responsive to the question, ‘Who is supposed to clean up this mess?’ [rather than]... ‘Who created this mess?’”

His discussion of rectificatory responsibility can be adapted to help students distinguish between personal and role rectificatory responsibility providing another way to analyze systemic roots of the financial crisis.

Such an approach to our article on the financial crisis will help students discover their own mental models and biases. This is particularly important given that the general public response to the financial crisis was, and to a great extent continues to be, to blame greed on Wall Street. While not denying that there are elements of greed on Wall Street, this common response points to what our colleague Scott Kelley refers to as the bias of common sense. As Kelley notes, it is one of “two problematic poles that business ethics education must avoid; the bias of common sense makes one’s own experience normative while the bias of conceptualism [the second pole] fails to account for cases or evidence that contradict or challenge deeply embedded mental models.”

Students need to consider questions about unintended consequences and responsibility from the perspective of all stakeholders, many of which are identified in the article. In addition, we want to challenge students to go beyond consideration of the mental models and biases that inform their responses to the financial crisis in general and ask them to consider the mental models and biases that inform their attitudes and responses to each of the stakeholders they identify. Doing so is one...
way to assist students in meeting the AACSB learning goals set out above.

**UNDERSTANDING THE FINANCIAL CRISIS**

In 2006, rising interest rates led to delinquencies and defaults by homeowners with sub-prime and adjustable rate mortgages. By 2007, these mortgage-related problems began to affect adversely financial structures linked with sub-prime mortgage loans. This set off a downward spiral in the value of residential real estate and in the prices of related structured financial obligations, which in turn affected other similar financial instruments and the institutions—primarily financial—that held them. The result is the financial crisis the aftermath with which we are still struggling today. There has been criticism of both financial institutions and the structured financial products that are at the heart of the crisis as well as a generally accepted conclusion that greed, especially among Wall Street executives, is at the root of the crisis. Because neither the criticism nor the conclusion is based on an analysis that considers the complexity of the situation, neither the criticism nor the conclusion adequately identifies benefits and harms that have been incurred, adequately apportions responsibility and accountability, or adequately points towards effective response strategies. Careful analysis of the complexities of the crisis will make it possible to address those inadequacies.

**HISTORICAL BACKGROUND**

From the 1930s, when the financial sector in the United States was restructured, until the mid 1970s, the roles of various financial institutions, including banks, savings and loans, stockbrokers, and insurance companies, were reasonably clear and distinct. Each of these types of financial institutions was regulated either at the federal or state level or both. Banks made commercial and personal loans including mortgages and took deposits (savings and checking). Banks often had trust departments and managed money for customers; some had bond departments that underwrote and traded U.S. government and municipal bonds.

Savings and Loan Associations (S&Ls) and Credit Unions were savings oriented institutions. They held customer funds in savings accounts, made mortgage loans and invested in government securities.
Credit Unions, hybrids between banks and S&Ls, were primarily savings institutions but could also offer checking accounts to their customers. Typically, credit unions did not make mortgage loans. Stockbrokers sold stocks and bonds to customers and underwrote stock issues and corporate bonds. They also managed money for customers and maintained an inventory of securities to sell to customers, as distinct from a trading book. Insurance companies were exactly that—they insured the life and property of their customers. Premiums paid to insurance companies by customers were partially allocated to reserve accounts to provide a source of funds to pay claims. Insurance companies invested these reserves in stocks and bonds as well as commercial real estate and mortgages. Finally, as the housing sector grew steadily after World War II, the essentially unregulated non-financial participants in housing finance—real estate agents, mortgage brokers, and mortgage loan companies—became more influential. The role of real estate agents did not change significantly. What did change was the greater range of institutions to which agents referred buyers seeking to obtain financing. This included mortgage brokers and mortgage loan companies, which began to have a visible impact on the mortgage loan market, particularly since the 1990s.

The distinctive roles that each type of financial institution played were dictated by government regulations. The Glass-Steagall Act (1933) regulated what banks were allowed to do, effectively separating banks from stockbrokers. The McFadden Act (1927) prohibited interstate banking. The Federal Reserve Act’s (1913) Regulation D, which has been amended many times over the years, regulates reserve requirements thereby affecting the interest rate environment that differentiated the types of accounts that banks and S&Ls were able to offer to their clients.

One might say that the creation in the 1960s of the Certificate of Deposit (CD) by Walter Wriston of First National City Bank (now Citibank) was, ironically, the seed that grew into the current crisis. The CD was the first substantive change in financial regulation since the 1930s. By the 1970s, the distinctions between financial institutions began to erode as stockbrokers, such as Merrill Lynch and Morgan Stanley, found ways to attract the checking and savings account balances traditionally held by commercial banks and S&Ls. In addition to this disintermediation, stockbrokers began underwriting commercial loans and selling them off to banks and insurance companies, thereby retaining no ongoing risk in the transaction. This is about the time when stockbrokers began to be referred to as investment banks.
In response to these changes, commercial banks began to seek ways to expand their businesses. Laws governing branch banking and interstate banking began to change, making it possible for banks to expand their networks within and across state lines. In addition, banks were allowed to establish non-bank subsidiaries that could offer brokerage services to their customers. For their part, S&Ls began to make commercial mortgages. At the same time, stockbrokers/investment banks began to lose fee income from their traditional businesses; to compensate for these losses, they began to trade more actively in fixed income securities. The development of the financial futures and options markets created more tools with which to manage trading, credit, and interest rate risk and with which to create new financial products. Mergers among the stockbrokers created economies of scale and expanded the customer bases. The larger stockbrokers in the major cities with national and international networks were now known as investment banks and the smaller more regional oriented firms, with a few exceptions, remained identified as stockbrokers.

As deregulation gained steam in the 1980s, banks started to merge. Credit cards became an integral part of the consumer’s financial picture and reduced the consumers’ use of checking accounts to pay for transactions. Disintermediation of the banks’ and S&Ls’ sources of low cost deposits continued to erode margins and reduce return on equity. Expanding economies at home and abroad created increased financing opportunities and the banks and S&Ls began to rely more heavily on wholesale deposits—money purchased in the money markets—to fund loans. The Eurodollar market continued to expand as countries around the world reduced controls on capital flows and technology enabled financial institutions around the world to participate in what had become an international dollar-denominated money market. Confidence and reputation were becoming more important aspects of international financial markets as participants relied more heavily on regulators and rating agencies to assess financial strength and less on “local” knowledge.

Investors were increasingly looking for higher yields on fixed income securities and sought the best performing equities. Advances in communications and technology in the 1990s enabled consumers and investors to have more information readily available and enabled institutions to leverage intellectual creativity, i.e. financial engineering. To offset lower margins on traditional businesses, banks sought more fee income as well as ways to reduce risk and move assets (commercial loans,
credit card receivables, auto loans, mortgages, etc.) off their books in efforts to increase return on assets and equity.

By the 1990s, investment banks were expanding their role as arrangers of financing for commercial and institutional borrowers and often retained on their own books portions of the deals they arranged. Despite a broadened business base, continued consolidation, and globalization, the fee income of investment banks was constantly under pressure. The demand for better yields fueled the creation of more structured investment vehicles (SIV). These not only met investor needs, they also provided attractive fee income for the financial institutions that structured them. As trading activities were increased, more capital was required to support them. Regulators expanded the definition of capital and adopted more sophisticated methods for assessing risk, which enabled leverage to increase.

Traditionally, investment banks were partnerships with partners risking their own capital in support of the firms’ activities. Partners were compensated for this risk by sharing in the firms’ profits. By the 1990s, the capital/equity required to support the varied businesses of investment banks outstripped the ability of the partners to provide it. Consequently, the investment banks started to go public. The partners of the once private firms were now executives in publicly owned investment banks, and while they owned some of the stock in these publically traded firms, they also had considerable wealth outside the firm. No longer were they risking substantially all their own capital; non-executive shareholder capital was at risk as well. Despite the changed ownership of the capital at risk, the compensation structure changed little. These executives still risked capital in the same ways as before and, if successful, were still rewarded in essentially the same way as before, even though they were risking a significantly smaller proportion of their own capital. Additionally, the consequences of a bad year were not as dire as they had been before.

Both banks and investment banks competed for the best talent and compensation soared in the 1990s as the business of both the banks and investment banks was good. New participants in the financial markets, such as hedge funds, private equity funds, and buyout funds, began to emerge; at the same time insurance companies became more active, seeking more direct access to investment opportunities. The initial focus of many of these new investment managers was the creation of investment strategies to diversify or hedge risk away from traditional equity and fixed income markets, i.e. the investments were not closely
correlated to movements in traditional stock and bond markets. If the U.S. equity markets declined, the hedge fund investments would not decline as much, would stay the same, or would increase. As a result, these funds became generically referred to as hedge funds. Hedge funds and insurance companies along with various types of private equity funds and mutual funds also competed for business and talent. Compensation, especially bonuses for performance, was the single most important factor in retaining and hiring staff. Regardless of whose capital was at risk, success was handsomely rewarded but failure did not produce proportional adverse consequences. The bias was to embrace risk rather than to limit it.

Meanwhile, the real estate market continued what seemed to be an unstoppable rise. Increased financing sources lessened the role of banks and S&Ls in originating mortgages. By the mid-1990s unregulated private mortgage brokerages and mortgage finance firms, such as Countrywide Financial and New Century Financial, played significant roles in mortgage loan origination and placement. Real estate agents had more choices as they helped buyers find financing in order to make a sale—and earn a commission.

Compensation for mortgage brokers was largely commission based. Competition was intense and investors were still searching for better yields. New financial instruments were created to meet the yield requirements of various types of investors while ostensibly limiting risk. Rating agencies had a key part in assessing risk, assuring investors, and lessening the need for or role of independent analysis or thought by the investor. Simultaneously, as successive administrations sought increased home ownership as a positive social policy, government sponsored entities established to support housing finance—Fannie Mae, Freddie Mac, FHA, Ginny Mae, and Federal Home Loan Banks—were being pushed to expand their role. The demand to create mortgages was intensified as the many different parties involved sought to profit from an expanding housing sector. Home builders, appraisers, inspectors, title companies, casualty insurers, and lawyers also stood to benefit, as did the home buyer. Long term home owners saw the value of their home rise steadily. The ready availability of financing and the willingness to take on increased leverage/debt were perhaps the key elements that facilitated the booming housing industry—more homes, higher prices, more buyers, and a repeat of the cycle.

Meanwhile, countries around the world continued to reduce barriers to capital flows. World debt and equity markets became easily accessible.
Financial firms expanded globally and home ownership expanded in most developed countries. The expanding economies in Asia saw their foreign currency reserves rising rapidly; in the Middle East and Russia, oil related wealth was soaring; and in Europe economic stability preserved traditional wealth in the north, while economic growth was creating new wealth in the south and east. As in the United States, institutional and individual investors desired better yields than were available with government securities.

By the early part of the decade 2000s, banks and investments banks had gone through a period of significant mergers and acquisitions. Of the approximately 20 large national stockbrokers (investment banks) that existed in the 1970s, only two remain as independent entities: Goldman Sachs and Morgan Stanley. Of the 60 largest banks in the United States in 1980 only 16 remain. The six banks that appeared before congress on February 11, 2009 had merged with or acquired 33 of what had been the 50 largest banks in 1980. These six banks have their head offices in four cities, New York (3), Boston, Charlotte, and San Francisco. The 33 legacy banks were headquartered in 14 cities. The consolidation of banks and investment banks has concentrated financial risk in a few large financial institutions that are the dominant institutions in most major metropolitan areas across the country.

Since the 1970s, there have been numerous economic or financial “crises” of one sort or another but none had the same broad reach across the country as the current crisis has had. The institutional and geographic diversification of financial institutions that once existed and that might have mitigated a nationwide crisis no longer exists. The mergers among financial institutions were not blocked by the Department of Justice because there seemed to be no restraint of trade in financial services. These mergers did, however, create a systemic risk that did not exist previously. The burgeoning risk to a proper functioning financial system should have been addressed when financial institutions got “too big”, not later when they got “too big to fail”.

By 2006, all the elements of the boom were well synchronized. Not only was there deregulation, there were also instances where regulatory oversight appears to have been lax. Home ownership was the quixotic standard leading the markets in various ways. The demand and drive for enhanced yield and better investment returns dulled investor analysis. At the same time, readily available financing, investment capital, intellectual and technological capacity and innovation all facilitated the development of instruments designed to meet this demand. At all levels, attractive
compensation incentives—especially pay for performance—focused individual and institutional efforts on achieving increased returns. Like users of the internet networking site LinkedIn, these elements became “LinkedIn” for the perfect financial storm.

**SHARED RESPONSIBILITY**

As we have seen, the development of the financial sector over the past 35 years points to the causes that shaped the environment which spawned the current crisis. These causes include, but are not necessarily limited to the following:

- Corporate governance
- Compensation
- Housing
- Regulatory actions
- Investor expectations
- Fraud and other criminal activity
- Naiveté and/or ignorance
- Liquidity
- Leverage
- Low cost of capital
- Acceptance of risk

Those institutions and individuals who share some degree of culpability for the excesses of the boom include, but are not necessarily limited to the following:

- Banks
- Investment banks
- Investors
- Insurance companies
- Hedge funds
- Mortgage brokers and mortgage loan companies
- Consumers
- Politicians
- Rating agencies
- Experts and specialist

There are many contributing factors to the crisis. They are macro and micro, domestic and global. They involve public and private sectors, financial and non-financial corporations and institutions, and individuals and society. At the end of the day, however, it comes down to individual
choices and actions. As the saying goes, “We have met the enemy and they are us.”\textsuperscript{6} We as a people, whether acting individually or collectively, neither exercised responsibility in making decisions nor took ownership of the consequences of actions stemming from those decisions. We were quite willing to pass the buck, to make it someone else’s problem. For the most part, we did not ask all the questions or get all the information needed to make an informed decision. We relied on experts and specialists who told us what we wanted to hear. If perchance an expert sounded a warning or provided an analysis that did not fit our view of the situation, we more often than not simply ignored the warning. The result was a mutually supported cycle of self-deception that perpetuated the mortgage fueled boom.

A brief comment about mortgage products and the market for them will be helpful before moving on to a discussion of the ethical dimensions of the crisis. It is important to differentiate the more traditional types of mortgages—which have been made, packaged and sold for decades—from more questionable non-traditional mortgage structures. Both traditional mortgages and the collateralize mortgage obligations (CMO) that contained them had stood the test of time until roughly 2007. Non-traditional mortgages—sometimes referred to as “abusive” mortgages—and the CMOs that contained them are at the heart of what precipitated the current crisis. Prior to 2000, the mainstay of traditional mortgage products were fixed and adjustable rate mortgages with a typical down payment of 10\% to 20\% and documentation of employment, income, assets, and liabilities.

By 2000, loan applications with less extensive documentation, especially verification of income, began to spread. With real estate values continuing to rise, the housing industry was a major driver of economic growth. There seemed to be a commonality of purpose among all participants to keep it growing. To qualify a broader array of buyers and increase home ownership, new products were developed, many targeted to qualify “sub-prime” borrowers—that is those who had poor credit scores, unreliable income, etc. These new products included:

- No or low documentation loans that did not verify income or employment
- 100\% or greater financing
- Teaser or below market rates in the early years of a mortgage
- Interest only loans
- Flexible payment loans
While some of these products met real and legitimate market needs, it is not clear that all of them did so. Understanding the purpose and target market will assist in distinguishing among these products.

In theory these new products were developed to help home buyers who could not qualify for financing under traditional lending standards. It was argued that they would benefit financially from stable housing expenses and from the ability to participate in rising real estate prices. At the same time, investors—especially sophisticated ones—desired better yields on their investments, while still mitigating risk. To bring together these two groups—buyers who did not qualify for traditional mortgages and investors seeking higher yields—mortgage loans of varying types and quality were packaged into CMOs. They offered diversification of risk, which is a desired trait in portfolio theory that is not easily achieved by the individual investor.

Mathematical models, which incorporated probability theory, were used to structure these CMOs in order to create a bundle of mortgages (referred to as mortgage pools) which taken as a whole offered moderate risk (as a result of diversification) but provided an enhanced return (as a result of including in the portfolio non-traditional mortgages that commanded the higher rates). These mortgage pools were rated by rating agencies, such as Moody’s, Standard & Poor’s, and Fitch.

As investors demanded higher yields and the mortgage, banking, and investment banking industries searched for more ways to increase return on equity and assets—in part to satisfy investors—more sophisticated, more complicated, and riskier mortgage pools were created. It became increasingly difficult to evaluate the effect of the interaction of interest rates, delinquencies, defaults and foreclosures, all of which started to rise in 2006. The crisis came to a head in the last half of 2006, most publically with the troubles of two Bear Stearns hedge funds holding CMOs. The main period of crisis was between March and October of 2007: Bear Stearns was rescued by JP Morgan Chase and the Federal Reserve; Lehman Brothers was forced to file for bankruptcy; Merrill Lynch was acquired by Bank of America; and Citibank and AIG were struggling to survive.

In looking back at the situation, it would appear that the scale of this crisis could have been lessened significantly. Of course, this would have required individuals and institutions to act in more socially responsible ways in order to provide a counterbalance to the cycle of self-deception driven by demands for ever increasing investment performance and
compensation packages and by social attitudes that encourage disregard for the other or stranger.

**ETHICAL DIMENSIONS**

The ethical dimensions of the current financial crisis are many and varied. In order to understand them better it will be helpful to examine the various institutions and individuals that bear some degree of responsibility for the crisis. While such an examination will not be exhaustive, it will consider the most significant contributors to the crisis. It is important to remember that while we look at these different contributors individually, they are not necessarily discrete contributing factors but are to one degree or another interrelated in the complex web of factors that contributed to the crisis.

Before discussing the ethical dimensions in reference to the various actors involved, it will be helpful to examine a few of the investment vehicles. It can be credibly argued that teaser rate mortgages and no-documentation mortgages are, from an ethical perspective, questionable. As the name suggests, teaser rate mortgages have a coercive element and the potential to be used in unethical ways to lure and/or be lured into purchasing a home with a mortgage that is beyond the ability of the borrower to repay. No-documentation mortgages ignore the traditional risk-reducing vetting processes in such a way that they create a “don’t ask, don’t tell” policy. This makes it possible for a broker to make a loan even if the broker suspects the borrower is unable to repay it. On the borrowers’ side, no-documentation loans make it easy for borrowers to deceive themselves into believing they can afford to purchase a home or to borrow knowing full well that they cannot afford to repay the mortgage. It is interesting to note that these no-documentation mortgages are commonly referred to as “liar’s loans”; perhaps that is because by design they sanction a situation that encourages dishonesty.

It is important, however, to recognize that the majority of mortgage instruments are structured to meet legitimate needs and demands. For example, much concern has been expressed about interest-only loans. This type of loan is a very appropriate financial tool in the correct circumstances. For instance, in the United States, it is common practice in many law firms to pay partners at the end of the fiscal year. Say an attorney, who will be receiving a $400,000 distribution on December 31, has two children in university and is faced with $63,000 in tuition payments on September 1. An interest-only loan is an appropriate
financial instrument for a person in this situation. The same cannot necessarily be said of using this type of loan to assist a person, who has few assets and a moderate income, to purchase a home. From an ethical perspective, the issue is not so much about the mortgage instruments themselves, but whether or not they were used for the purposes for which they were designed. Asking such a question pushes us to consider the various actors, their corporate and individual responsibilities, and the degree to which they acted irresponsibly and/or unethically.

**Brokers**

The role of mortgage brokers is to match borrowers with lenders. However, their responsibilities are not necessarily clear cut. Often mortgage brokers market their services to real estate agents, since real estate agents refer their clients to the brokers. Once a relationship has been established, the broker assists home buyers in finding suitable financing for the home being purchased. At the same time, mortgage brokers are responsible for vetting the borrower on behalf of the lender. A broker’s income is generated by placing a mortgage with a lender; thus, it is in the broker’s interest to find a loan for the borrower. Once the mortgage is placed, the broker has no further responsibility for it and does not share in any risk if the borrower should default on the loan. This structure creates an inherent conflict of interest.

While there are some obligations to the lender, such as insuring that the required documentation is accurate, there are few if any obligations to the borrower. In addition, borrowers often view brokers as experts or specialists; this leads to a situation in which there is a potential power imbalance. Do brokers have a responsibility to inform borrowers that they do not have the financial means to buy a home? Or do borrowers have the sole responsibility for determining the level of debt they can carry? While most brokers practice their trade with integrity, the human faces of the current crisis make it clear that there have been brokers who have abused the power imbalance and convinced borrowers to take out loans that they did not have the financial means to support. It is also clear that there have been borrowers who knew the risks involved and willingly accepted them. Those who acted irresponsibly and/or unethically at this level have contributed to the crisis, but they are not solely responsible for it. Lenders and investors have were also contributors to the crisis.
LENDERS

The changes in the financial services industry described in the first part of this article raise a number of concerns. One is the degree to which lenders are responsible for the soundness of loans which they originate. For the most part, non-bank lenders, i.e. mortgage loan companies, no longer have personal relationships with borrowers. This makes it more difficult to assess risk accurately. In addition, many mortgage loans originated by both bank and non-bank lenders are no longer retained by the originating lender. While the originating lender might still service the loan, it no longer shares in any of the risk related to the loan. This has the potential of creating a two tiered lending structure, with less rigorous standards being used for loans that will not be retained on the originating lender’s books but will be bought by investors who are prepared to accept the higher risk for an enhanced return.

Another concern deals with responsibility for structured investment vehicles, such as Collateralized Debt Obligations (CDOs). What, if any, responsibility do the creators of these instruments have, particularly for unintended consequences? These instruments were created in response to ever increasing demands of investors for greater yield on their investments. They are fairly sophisticated instruments based on mathematical models that assumed constant liquidity in the market and an expanding economy with good employment opportunities and rising real estate values. Should the creators or marketers of these instruments provide some type of warrant or guarantee that would come into play if conditions change and the assumptions upon which the models are based are no longer valid? In other words, should those who structured the instruments retain some risk in the transaction? Presumably, this would require them to maintain capital to support the transaction.

Some of the instruments used mortgages for purposes other than those they were originally intended to accomplish, thereby changing the relationship with the borrower or the nature of the involvement of the borrower. It can be argued that some banks and investment banks placed more emphasis on creating mortgages as investment vehicles for investors rather than as financing for home buyers. For most, buying a home is one of the most significant financial transactions of their lives. Borrowers would normally expect some sort of relationship with the lender or at least the ability to meet with the lender to discuss and resolve problems should they occur. But as mortgages got packaged into CMOs and CDOs, borrowers found it more difficult to identify the holder of the mortgage in order to seek decisions about adjustments to it if the
borrowers’ circumstances changed. Often lenders who sold mortgages and certainly the holders of CMOs and CDOs did not see themselves in a relationship with the borrower. For them, a person’s decision to finance a home purchase simply provided an opportunity to make an investment; it was a purely financial transaction the aim of which was to maximize returns on investment. The borrower simply became a means to an end. With no sense of relationship or responsibility to the borrowers, the borrowers’ legitimate claims can easily be dismissed. The imbalance of power, which has been built into the system, must be redressed. The appropriateness of these instruments can also be questioned. The existence of a demand for larger returns on the part of investors does not necessarily justify satisfying it.

A third concern centers on performance. The pressure to produce ever better returns is great and comes from a variety of internal and external sources. It has created an extremely competitive environment within and among financial institutions, an environment that favors short-term gains over long-term success. This has fostered compensation systems with large up-front rewards and little or no subsequent risk, both of which limit accountability. This is exacerbated by the speed at which products are developed and investments and trades are made. In such an environment, decision making becomes reactive rather than proactive increasing the chance of making poor, uninformed decisions. While assigning responsibility for such an environment is difficult, it is clear, as we shall see, that many share in the blame.

**INVESTORS**

By definition, investors assume risk. When they do so with solid understanding of the risk involved based on information from trustworthy and reliable sources, there is no problem. Questions arise when investments are made with insufficient or unreliable information. Sophisticated investors have a duty to be well informed, to do due diligence in assessing various investment opportunities and associated risks, and to avoid over extending themselves—by employing leverage to make larger investments, for example—or stretching their investment criteria in ways that unfairly burden other investors in the market or more generally burden the larger community or society. While it has been argued that such burdens are unintended consequences of the actions of such investors, it is important to realize that those who have the capacity to make sound, informed decisions also have an obligation to do so.
When they should have known, could have know, but simply did not bother to know all the risks involved, they bear a degree of culpability for investment decisions gone wrong. They also have a responsibility for understanding the structure of the investment vehicles in which they place funds. That is, they should recognize that continued pressure for increased yields had a significant impact on the pricing and marketing of non-traditional and abusive mortgages packaged into CMOs and CDOs. As noted above, when an individual has the capacity to understand these sophisticated, complex investment structures, a claim of not knowing that harm could result when an investment went wrong is not credible.

Of course, not all investors are sophisticated investors. Some will have chased the market in an attempt to make a profit, with little real awareness of the risk involved or concern about the possibility of failure. These individuals share some responsibility for the crisis.

There are others, however, who are small, less well-informed investors. These individuals rely on experts and specialists who provide advice on investing. They, as well as sophisticated investors to a lesser extent, also rely on rating agencies that by definition are meant to be independent and unbiased in their ratings. The fact that these agencies are paid by the issuers of the securities that they are rating creates a potential conflict of interest that has the potential to influence the ratings that are issued. Here again, there is an issue of the responsible use of power and authority. Those who rely on the experts and specialists, who review, rate, and recommend investment opportunities, expect them to do so with integrity and impartiality. This is not always the case, as we learned from Enron and other scandals. At base these actions lead to a breakdown of trust; the resulting potential for harm not only impacts individual investors who acted on the advice and ratings given, but also impacts the economy and market as a whole.

It should be noted also that some argue that the market is not a place for the small, unsophisticated investor. While there is some merit to that argument, it is important to recognize that corporate actions and public policies have led people to invest in the markets, directly or indirectly. For the most part, an increasing number of American companies no longer provide pensions, or if they do so, the pensions do not necessarily cover the living costs of retirement. The same can be said about the income that retired workers receive through the Social Security scheme. It should be noted that the Social Security scheme, while often viewed as a retirement income scheme, was established to provide a safety net for retirees and others with special needs; it was never intended
to provide the sole income source in retirement. To reinforce this fact and to respond to the increasing numbers of people who would not have a pension at retirement, the government began to encourage people to save for their own retirement and established tax incentives for them to do so. This has forced millions of people, each with his or her own retirement investment accounts, into becoming investors in the market, who to one degree or another rely on the expertise and authority of specialist. Thus, it is fair to ask about the role of government and regulatory bodies in insuring fairness and transparency in the market.

**REGULATORY BODIES**

The regulatory process is complex and cumbersome. An in depth analysis of it is beyond the scope of this article. However, a few comments are in order; they will focus on aspects related to the regulation of the financial services industry. One concern centers on the relationship of regulators to industry specialists. Regulators must be knowledgeable and have a clear understanding of the businesses that they oversee and must exercise that oversight authority with the public good in mind. This is an extremely challenging task.

First, there are concerns about the impartiality of regulators. Some argue that they should not come from the ranks of industry specialists because they are so much a part of the system, which they are now called upon to regulate, that they are not able to regulate it in an impartial way that places the public good first. Others express concern about regulators’ relationships with industry leaders and especially the influence of politicians—often informed by lobbyists and special interests—who appoint senior regulatory officials, fund budgets of regulatory bodies, and from time to time insert themselves into the regulatory decision making process. The concern is that these situations lead to decisions that favor narrow interests rather than the interest of the public. In addition, there is concern that regulators who come from the ranks of industry specialists do not have a full appreciation of the public good and that they will be unwilling to exercise their authority when dealing with former colleagues. While there may be some merit to this argument, whether or not it is valid is difficult to assess, at the current time. It is clear however, that public perception, which is in part media driven, accepts the underlying accusation that appointing regulators who come from the ranks of industry is inappropriate and leads to a good-old-boys mentality.
This leaves the possibility of regulators coming from the ranks of academia and/or the ranks of civil service. While some argue that academics bring greater theoretical knowledge, in both cases concerns are raised about the lack of practical experience that these individuals bring to the task, a lack that is viewed as diminishing their ability to be effective. Of course, there are some academics who do have practical experience of a sort based on the consulting they do for companies in regulated industries. Here concerns are raised about their ability to be fair and impartial, much in the way they are raised about regulators from the ranks of industry. As can be seen there are no easy answers to ensuring that regulators are both knowledgeable about a very complex industry and able to exercise their authority to regulate it in an equitable way.

There is another fundamental concern about the regulatory system which also must be addressed. This focuses on the degree to which regulatory agencies have adequate resources to do their jobs effectively. These resources run the gamut from salaries and compensation schemes to the availability of appropriate technologies and the size and capability of support staff. If the resources of those in industry are significantly greater than those of regulators, it is difficult to see how regulators can keep up with the industry and its fast paced creation of new investment vehicles.

**Governance**

The current crisis has been discussed as a systemic failure of the structure of the financial system. This has a tendency to minimize the role of those responsible for governance of institutions, not only institutions in the financial services sector but also other institutions that have significant investment portfolios, such as pension funds, public funds (investments by cities, states, and other governmental bodies that invest cash surpluses), university endowments, and philanthropic organizations. Much has been written about the structure of governance, the process by which board members are selected, and the duties which they are charged to undertake. However, a few observations about governance in light of the financial crisis are in order.

In some cases there was a failure in the oversight function because they were unknowledgeable about the circumstances. Both in Europe and the United States there are numerous examples of banks who had concentrated their funds held for investment in CMOs and CDOs to such an extent that they no longer had the liquidity to meet their normal
operating requirements. Not only did boards allow an inappropriate concentration of assets in these investments; it appears that they also were not well informed of the risks inherent in these instruments. Just as investors do, those who are directly responsible for oversight of an institution have a responsibility to assess various investment opportunities and associated risks. In fact, it can be argued that they have an even greater responsibility as a result of their fiduciary responsibilities.

While public sector leadership is not usually a focus of discussions of governance, it should be noted that there have been similar failures of oversight among those responsible for public sector investments. Numerous municipalities in the US and Europe invested in CMOs and CDOs and the impact of those failed investments has been real, resulting in significant reductions in funds available for educational, social, and other public services.

Finally, the governance process often failed to align compensation with the long-term interests of the company as well as the interests of others with a stake in the company. When this happened, it had a greater tendency to provide an incentive to make decisions and take actions that were important contributing factors to the crisis.

CONCLUSION

This assessment of the ethical dimensions is not exhaustive. For example, it does not address the broader social context, which fosters a “me-first” attitude and a desire for instant gratification both of which seem to permeate American society. As individuals, we are all called to assess the degree to which we take responsibility for our own actions and decisions, personally and professionally. If we as individuals do not take these responsibilities seriously how can we expect others to do so? That said, we hope that what we have presented will be a catalyst for a fruitful exchange of ideas and thoughts on the financial crisis, which has had and will continue to have an impact on people across the globe.
NOTES

1 Earlier versions of this article were presented in March 2009 at a meeting of members of the Japan Society for Business Ethics Study in Tokyo, Japan and in August 2009 at the opening plenary session of the Society for Business Ethics annual meeting in Chicago, IL.


