The Global Financial Crisis of 2008: What Went Wrong?

Hershey H. Friedman, Ph.D.
Professor of Business and Marketing
Department of Economics
Brooklyn College of the City University of New York
E-mail: x.friedman@att.net

Linda W. Friedman, Ph.D.
Professor of Statistics & Computer Information Systems
Zicklin School of Business
Baruch College of the City University of New York
E-mail: Linda_Friedman@baruch.cuny.edu

Abstract

The current financial crisis that threatens the entire world has created an ideal opportunity for educators. A number of important lessons can be learned from this financial meltdown. Some are technical and deal with the value of mathematical models and measuring risk. The most important lesson, however, is that unethical behavior has many consequences. This debacle could not have occurred if the parties involved had been socially responsible and not motivated by greed. Conflicts of interest and the way CEOs are compensated are at the heart of this financial catastrophe that has wiped out trillions in assets and millions of jobs. The authors present a set of lessons as teaching opportunities for today's students and tomorrow's decision makers.

Key words: business education, business ethics, financial meltdown, self-interest, toxic mortgages, credit default swaps, regulation, and methods of compensation.

Electronic copy available at: http://ssrn.com/abstract=1356193

Introduction

The current financial crisis is the worst debacle we have experienced since the Great Depression. Millions of jobs have been lost and trillions of dollars in market value have evaporated. The entire world is suffering. The financial crisis is far from over and is adversely affecting people all over the world. Are there lessons that can be learned from this financial debacle? In fact, it is the perfect teaching tool since it makes so easy to demonstrate what can go wrong when firms do not behave in an ethically, socially responsible manner.

It is interesting to note that the financial meltdown of 2008 did not suddenly appear out of nowhere. The corporate world was heading down a dangerous path for more than 20 years. The authors feel that an early warning was the Savings and Loan disaster in which 1,043 banks failed with a cost to U.S. taxpayers of about $124 billion (Curry and Shibut, 2000). That happened between 1986 and 1995. The financial world ignored this warning. A few years later came several colossal corporate scandals including Enron, which filed for bankruptcy in late 2001, Tyco International, Adelphia, Global Crossing, WorldCom, and many other firms. These companies were found to use dubious accounting practices or engage in outright accounting fraud to deceive the public and enrich executives. In fact, the Sarbanes-Oxley Act of 2002 was enacted in order to prevent future financial disasters such as Enron. Suskind (2008) reports that Alan Greenspan, Chairman of the Federal Reserve, was at a meeting on February 22, 2002 after the Enron debacle and was upset with what was happening in the corporate world. Mr. Greenspan noted how easy it was for CEOs to "craft" financial statements in ways that could deceive the public. He slapped the table and exclaimed: "There's been too much gaming of the

Electronic copy available at: http://ssrn.com/abstract=1356193

system. Capitalism is not working! There's been a corrupting of the system of capitalism." This was another warning sign that it was easy for unrestrained greed to harm the entire economy.

The dot.com bubble which took place between 1995 and 2001 (NASDAQ peaked at over 5100 in March 2000), was a different kind of crisis. It was fueled by irrational spending on Internet stocks without considering traditional business models. Investors did not seem to care about earnings per share or other more traditional measures. Moreover, there were too many companies trying to create online businesses. The price of many dot-com stocks came tumbling down, but the bubble was not based on fraud as much as overvaluation of stocks (especially the IPOs) and excessive speculation. The housing bubble, on the other hand, that helped cause the current financial meltdown was fueled to a large degree by the ready availability of deceitful mortgages. What was apparent from the dot.com bubble was that prices cannot go up forever — a lesson not learned by those in the mortgage business.

Long Term Capital Management (LTCM), a hedge fund founded in 1994, which went out of business in 2000, showed how risky a highly-leveraged hedge fund could be. In 1998, LTCM had borrowed over $125 billion, but only had equity of $5 billion. The financial crisis started by LTCM at that time also demonstrated how the entire financial system could be at risk because of the actions of one fund. The Federal Reserve Bank was involved in a $3.5 billion rescue package in 1998 to protect the financial markets from a total collapse because of the actions of LTCM. One lesson that should have been learned from this financial debacle was not to rely so much on sophisticated mathematical models. LTCM's models were developed by two Nobel laureates – Myron Scholes and Robert C. Merton – who were both members of the board of the

hedge fund.

Lowenstein (2008) observes:

> Regulators, too, have seemed to replay the past without gaining from the experience. What of the warning that obscure derivatives needed to be better regulated and understood? What of the evident risk that intervention from Washington would foster yet more speculative behavior — and possibly lead to a string of bailouts?

Lowenstein (2008) states that only six months after the LTCM fiasco, Alan Greenspan "called for less burdensome derivatives regulation, arguing that banks could police themselves." Needless to say, Greenspan was proven quite wrong in this assertion.

The scandal involving Bernard Madoff which has been called the largest Ponzi scheme ever has also served to cast serious doubts on how well our financial system is being monitored. Gandel (2008) notes that KPMG, PricewaterhouseCoopers, BDO Seidman, and McGladrey & Pullen all signed off that all was well with the many feeder funds that had invested with Madoff. What has shocked everyone is that the auditors did not recognize that billions of assets were just not there. Auditors are supposed to check that the stated assets actually exist. Interestingly, Madoff himself was not a client of any of the large auditing firms; he used a tiny accounting firm in New City, NY that had only three employees. It is now apparent that this alone should have been an indication that something was very wrong with the way Madoff conducted business. One lawyer remarked: "All they really had to substantiate the gains of these funds was Madoff's own

statements. They were supposed to be the watchdogs. Why did they sign off on these funds' books?" (Gandel, 2008).

What can be learned from the above crises, especially the financial meltdown of 2008? First, we should recognize that what we have experienced is not the breakdown of an economic system. This is a values meltdown more than anything else. In fact, a recent poll showed that bankers are near the bottom of the list when it comes to respect felt by the public and barely beat prostitutes and convicted felons (Norris, 2009).

Lesson: Is the Pursuit of Self-Interest Always Good?

One pillar of mainstream economics taught in all economics classes is based on the famous saying of Adam Smith in his classic work, *Wealth of Nations*: "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest." Smith demonstrated how self-interest and the "invisible hand" of the marketplace allocates scarce resources efficiently. Students are taught that "economic man" or *homo economicus* acts with perfect rationality and is interested in maximizing his/her self-interest. This results in an economic system (capitalism) that is efficient and productive. For the corporation, self-interest is synonymous with maximization of profits and/or maximization of shareholder wealth. Indeed, students are being taught that self interest + free markets + deregulation results in prosperity for everyone. The famous speech by Gordon Gekko in the

movie *Wall Street* is based on the idea that the pursuit of self-interest is good for all of us (available at: http://www.americanrhetoric.com/MovieSpeeches/moviespeechwallstreet.html):

> Greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures the essence of evolutionary spirit. Greed in all of its forms, greed for life, for money, for love, knowledge has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA.

Change the word "greed" to pursuit of self-interest and you have in effect what has been taught to millions of business and economics students. Even the so-called watchmen and gatekeepers — corporate directors, investment bankers, regulators, mutual funds, accountants, auditors, etc.— have fallen into the self-interest trap and disregarded the needs of the public (Lorsch, Berlowitz, and Zellecke, 2005).

It is ironic that the discipline of economics started as part of the discipline of moral philosophy, and even became a moral science (Alvey, 1999). Adam Smith, in his first book, *The Theory of Moral Sentiments*, made it clear that he believed that economic growth depended on morality. To Smith, benevolence — not pursuit of self-interest — was the highest virtue (Alvey, 1999). The following quotation from Smith's *The Theory of Moral Sentiments* demonstrates what Smith actually believed: "Man ought to regard himself, not as something separated and detached, but

as a citizen of the world, a member of the vast commonwealth of nature and to the interest of this great community, he ought at all times to be willing that his own little interest should be sacrificed."

Robinson (2007) made the point more than 30 years ago that the pursuit of self-interest has caused much harm to society and that Adam Smith should not be associated with this doctrine. In actuality, Smith believed that "society, however, cannot subsist among those who are at all times ready to hurt and injure one another." Raw self-interest without a foundation of morality is not what Adam Smith is all about. Robinson ended a commencement address with the following warning: "I hope … that you will find that the doctrines of Adam Smith are not to be taken in the form in which your professors are explaining them to you" (Robinson, 2007).

Howard (1997) uses the expression "tragedy of maximization" to describe the devastation that the philosophy of maximizing self-interest has wrought. Unrestrained capitalism that is obsessed with self-interest and is unconcerned about the long-run, can lead to monopoly, inequitable distribution of income, unemployment, and environmental disaster (Pitelis, 2002).

In 1937, at his second inaugural address, President Franklin D. Roosevelt stated: "We have always known that heedless self-interest was bad morals; we know now that it is bad economics." (Roosevelt, 1937). Lawrence H. Summers, in a 2003 speech to the Chicago Economic Club made the following remark: "For it is the irony of the market system that while its very success depends on harnessing the power of self-interest, its very sustainability depends

upon people's willingness to engage in acts that are not self-interested."

The financial meltdown of 2008 shows quite clearly what happens when everyone is solely concerned with self-interest. Closely tied to the concept of pursuit of self interest is the belief that free markets do not need regulation. Many economists and CEOs promoted the belief that capitalism could only work well with very little regulation.

Lesson: Free Markets and the Role of Regulation

There has been a small movement in economics that questions the neoclassical model in economics and its belief that free markets and laissez-faire economics will solve all problems (Cohen, 2007). According to one economist, only 5% to 10% of America's 15,000 economists are "heterodox," i.e., do not follow the neoclassical model promoted by free market enthusiasts such as Milton Friedman. Some heterodox economists feel that neoclassical economics has become "sycophantic to capitalism"; the discipline is concerned with mathematical solutions that do not resemble the real world. The discipline is more concerned about models than solving social problems (Monaghan, 2003).

Lichtblau (2008) believes that the Federal government did not do a good job monitoring Wall Street. He cites what Arthur Levitt, former chairman of the SEC said regarding his former agency: "As an overheated market needed a strong referee to rein in dangerously risky behavior, the commission too often remained on the sidelines." Sean Coffey, who used to be a fraud

prosecutor, also was not happy with the performance of the SEC: The SEC "neutered the ability of the enforcement staff to be as proactive as they could be. It's hard to square the motto of investor advocate with the way they've performed the last eight years." Not only was there a relaxation of enforcement, there was also a reduction in S.E.C. staff. Coffey asserts that the administration used the argument that loosening up regulations was necessary in order to make it possible for American companies to compete globally (Lichtblau, 2008). Senator Charles E. Schumer also believed that the rules had to be changed to encourage free markets and deregulation if the United States was to remain competitive (Lipton and Hernandez, 2008).

The problems began at a meeting on April 28, 2004 between five major investment banks and the five members of the S.E.C. The investment banks wanted an exemption from a regulation that limited the amount of debt – known as the net capital rule – they could have on their balance sheets. By increasing the amount of debt, they would be able to invest in the "opaque world of mortgage-backed securities" and credit default swaps (CDSs). The S.E.C. agreed to loosen the capital rules and also decided to allow the investment banks to monitor their own riskiness by using computer models to analyze the riskiness of various securities, i.e., switch to a voluntary regulatory program (Labaton, 2008). The firms did act on the new requirements and took on huge amounts of debt. The leverage ratio at Bear Stearns rose to 33:1; this made the firm very risky since it held only $1 of equity for $33 of debt. Regarding what transpired, James D. Cox said (Labaton, 2008):

> We foolishly believed that the firms had a strong culture of self-preservation and responsibility and would have the discipline not to be excessively borrowing. Letting the firms police themselves

> made sense to me because I didn’t think the S.E.C. had the staff and wherewithal to impose its own standards and I foolishly thought the market would impose its own self-discipline. We’ve all learned a terrible lesson.

Alan Greenspan finally admitted at a congressional hearing in October, 2008 that he had relied too much on the “self-correcting power of free markets” (Andrews, 2008). He also acknowledged that he did not anticipate the “self-destructive power of wanton mortgage lending” (Andrews, 2008). Greenspan was asked whether his ideology – i.e., belief in deregulation and that government regulators did not do a better job than free markets in correcting abuses – contributed to the financial crisis. He admitted that he had made a mistake and actually took partial responsibility. Some of the mistakes Greenspan had to with risky mortgages and out of control derivatives:

Sub-Lesson: Risky Mortgages

He allowed the growth of highly risky and fraudulent mortgages without recognizing the “self-destructive power” of this type of mortgage lending with virtually no regulation (Skidelsky, 2008). The Fed could have put a stop to it by using its power under a 1994 law (Home Owner Equity Protection Act) to prevent fraudulent lending practices. It was obvious that the mortgage industry was out of control and was allowing individuals with very little money to borrow huge sums of money. Greenspan could also have used the monetary powers of the Fed to raise interest rates which would have ended the housing bubble.

Here are just a few examples of how deregulation affected the subprime mortgage market:

WaMu, for example, lent money to nearly everyone who asked for it. Loan officers were encouraged to approve mortgages with virtually no checking of income (Goodman and Morgenson, 2008).

To encourage people with little income to borrow money, WaMu used option ARMs (Adjustable Rate Mortgages). The very low initial rates enticed people to take out mortgages. Of course, many borrowers thought the low payments would continue indefinitely and would never balloon (Goodman and Morgenson, 2008). The number of ARMs at WaMu increased from 25% (2003) to 70% (2006). It did not take long for word to spread that WaMu would give mortgages to nearly anyone. WaMu even ran an advertising campaign telling the world that they would give mortgages to anyone, "The Power of Yes." WaMu did exactly that: it approved almost every mortgage. Revenues at WaMu's home lending unit increased from $707 million to approximately $2 billion in one year . As one person noted: "If you were alive, they (WaMu) would give you a loan. Actually, I think if you were dead, they still would give you a loan" (Goodman and Morgenson, 2008).

In the mortgage business, NINJA loans are mortgage loans made to people with "No Income, No Job or Assets." These mortgage loans were made on the basis of unsubstantiated income claims by either the applicant or the mortgage broker or both. There are stories of individuals with income of $14,000 a year purchasing $750,000 homes with no money down and no mortgage

payments for two years (Friedman, 2008). Other types of mortgages that became popular include "balloon mortgage" (borrower only makes the interest payment for 10 years but then has to pay a huge amount—the balloon payment); "liar loan" (borrower claims an annual income, no one checks and there is no documentation); "piggyback loan" (this combines a first and second mortgage so a down payment is not necessary); "teaser loan" (mortgage at very low interest rate for first two years but when it is readjusted after the two years, the borrower does not have the income to make the payments); "option ARM loan" (discussed above); and the "stretch loan" (borrower has to use more than 50% of his monthly income to make the mortgage payments) (Pearlstein, 2007).

President Bush wanted to encourage homeownership, especially among minorities. Unfortunately, his approach which encouraged easy lending with little regulation, helped contribute to the financial crisis (Becker, Stolberg, and Labaton, 2008). The increase in homeownership was accomplished through the use of toxic mortgages. President Bush also encouraged mortgage brokers and corporate America to come up with innovative solutions to enable low-income people to own homes. L. William Seidman, an advisor to Republican presidents, stated: "This administration made decisions that allowed the free market to operate as a barroom brawl instead of a prize fight." Bush's banking regulators made it clear to the industry that they would do everything possible to eliminate regulations. They even used a chainsaw to symbolically show what they would do to the banking regulations. Various states, at one point, did try to do something about predatory lending but were blocked by the Federal government. The attorney general of North Carolina said: "They took 50 sheriffs off the beat at a time when lending was becoming the Wild West" (Becker, Stolberg, and Labaton, 2008).

The policy of encouraging homeownership affected how Fannie Mae and Freddie Mac conducted business. Fannie and Freddie are government-sponsored, shareholder-owned companies, whose job is to purchase mortgages. They purchase the mortgages from banks and mortgage lenders, keep some and sell the rest to investors. This enables banks to make additional loans thus allowing more people to own homes. Fannie and Freddie were encouraged by President Bush to do everything possible to help low-income people buy homes. One way to accomplish this was to reduce the down payments. There was a drive to allow new homeowners to obtain a federally-insured mortgage with no money down. There was little incentive to do something about the super-easy lending practices, since the housing industry was helping to pump up the entire economy. The increasing home values helped push consumer spending. More and more people were becoming homeowners in line with what President Bush wanted.

Back in the year 2000, Fannie Mae, under CEO Franklin D. Raines and CFO J. Timothy Howard decide to expand into riskier mortgages. They would use sophisticated computer models and rank borrowers according to how risky the loan was. The riskier the loan, the higher the fees that would be charged to guarantee the mortgage. The big risk was if a huge number of borrowers would be unable to make the payments on their mortgages and walk away from their obligations. That danger was not seen as likely in 2000; moreover, the computer models would ensure that the higher fees for the riskier mortgages, would offset any losses from mortgage defaults. The company announced that it would purchase $2 trillion in loans from low-income (and risky) borrowers by 2010 (Duhigg, 2008).

What this accomplished – besides enriching the executives at Fannie Mae – was that it made subprime mortgages that in the past would have been avoided by lenders, more acceptable to banks all over the country. These banks did not have the sophistication or experience to understand the kind of risk they were taking on. Between 2001 and 2004, the subprime market grew from $160 billion to $540 billion (Duhigg, 2008). In 2004, there were allegations of accounting fraud at Freddie and Fannie and both had to restate earnings. Daniel H. Mudd became CEO of Fannie Mae in 2005 after Raines and Howard resigned from Fannie Mae under a cloud. Under Mudd's watch, Fannie purchased even riskier mortgages—mortgages that were so new that the computer models could not analyze them properly. Mr. Mudd was warned by Enrico Dallavecchia, his chief risk officer, that the company was taking on too much risk and should charge more. According to Dallavecchia, Mudd's response was that "the market, shareholders, and Congress all thought the companies should be taking more risks, not fewer. Who am I supposed to fight with first?" (Duhigg, 2008).

As early as February 2003, Armando Falcon, Jr., who ran the Office of Federal Housing Enterprise Oversight (OFHEO), wrote a report that warned that Fannie and Freddie could default because they were taking on far too many mortgages and did not have the capital to protect themselves against losses. Falcon almost got fired for this report. After some accounting scandals at Freddie, the President decided to keep Falcon on. A bill was written by Michael Oxley, a Republican and Chairman of the House Financial Services Committee that would have "given an aggressive regulator enough power to keep the companies from failing" (Becker, Stolberg, and Labaton, 2008). Since the bill was not as strong as what President Bush wanted, he opposed it and it died in the Senate. The bottom line was that in Bush's desire to get a

tougher bill, he ended up with no bill at all. Eventually, James B. Lockhart III became the Director of the OFHEO. Under his watch, Freddie and Fannie purchased $400 billion of the most risky subprime mortgages. In September, 2008, the Federal government had to take over Fannie Mae and Freddie Mae.

Sub-Lesson: Derivatives out of Control

Greenspan also admitted that he allowed the market for derivatives to go out of control. Greenspan was opposed to the tighter regulation of derivatives going back to 1994 (Andrews, 2008). George Soros, a renowned financier, avoided derivatives "because we don't really understand how they work'; Felix G. Rohatyn, the prominent investment banker, called derivatives "potential hydrogen bombs"; and Warren E. Buffett remarked that derivatives were "financial weapons of mass destruction." Greenspan, on the other hand, felt that "derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing and capable of doing so" (Goodman, 2008).

Greenspan also admitted that the market for credit default swaps (CDS) which became a multi-trillion dollar business went out of control (Andews, 2008). The CDSs were originally developed to insure bond investors against default risk but they have taken on a life of their own and have been used for speculation purposes. A CDS is a credit derivative and resembles insurance since the buyer makes regular payments and collects if the underlying financial instrument defaults. In a CDS, there is the protection buyer who can use this instrument for credit protection; the protection seller who gives the credit protection; and the specific bond or

loan that could go bankrupt or into default is the “reference entity.” It could be compared to buying fire insurance on someone else’s house. Imagine how the insurance industry would work if 1,000 people were able to buy fire insurance on Jane Doe’s house. With traditional insurance, if Jane Doe’s house burns down, there is only one payment. If, on the other hand, 1000 people were allowed to each own a fire insurance policy on Jane Doe’s home, one thousand payouts must be made. The insurance company would be collecting fees from 1,000 customers and have a nice revenue stream, but the risk would be very great. In fact, we would have a situation where one thousand people would do everything possible to make sure the Jane Doe home burns down.

Another difference between a CDS and traditional insurance is that there is a market for the CDS which enables speculation since the owner of the CDS does not actually have to own the underlying security. One problem with this is that a hedge fund can buy a CDS on a bond and then do everything possible (e.g., sell the stock short to force the price of the stock down) to make sure that the reference entity does indeed default (Satow, 2008).

It should be noted that the market for derivatives and CDSs became unregulated thanks to the Commodity Futures Modernization Act of 2000. This law was pushed by the financial industry in the name of free markets and deregulation. It also made it virtually impossible for states to use their own laws to prevent Wall Street from doing anything about these financial instruments. This bill was passed “at the height of Wall Street and Washington’s love affair with deregulation, an infatuation that was endorsed by President Clinton at the White House and encouraged by Federal Reserve Chairman Alan Greenspan” (Kroft, 2008).

According to Eric Dinallo, the insurance superintendent of New York State (Kroft, 2008):

> "As the market began to seize up and as the market for the underlying obligations began to perform poorly, everybody wanted to get paid, had a right to get paid on those credit default swaps. And there was no 'there' there. There was no money behind the commitments. And people came up short. And so that's to a large extent what happened to Bear Sterns, Lehman Brothers, and the holding company of AIG. It's legalized gambling. It was illegal gambling. And we made it legal gambling…with absolutely no regulatory controls. Zero, as far as I can tell.

In response to the question as to whether the CDS market was like a “bookie operation,” Dinallo said: "Yes, and it used to be illegal. It was very illegal 100 years ago."

SEC Chairman, Christopher Cox, stated that it is of utmost importance to bring transparency to the unregulated market in CDSs. They played a major role in the financial meltdown and were also the cause of the near bankruptcy of AIG which necessitated a government bailout (Landy, 2008; Cox, 2008). According to Landy (2008), No one even knows the exact size of the CDS market; estimates range from $35 trillion to $55 trillion. When AIG was bailed out by the

Federal government it held $440 billion of CDSs (Philips, 2008).

One banker from India made the point that his colleagues were surprised at the "lack of adequate supervision and regulation." What made this even more amazing that all this occurred after the Enron debacle and the passing of the Sarbanes-Oxley bill (Nocera, 2008). In fact, India avoided a subprime crisis because a bank regulator by the name of V. Y. Reddy, who was the opposite of Greenspan, believed that if "bankers were given the opportunity to sin, they would sin." Unlike Greenspan, he felt that his job was to make sure that the banking system would not be part of a huge real estate bubble. He used his regulatory powers to deflate potential bubbles by not allowing bank loans for the purchase of undeveloped land. Bankers were not happy that Reddy was preventing them for making huge amounts of money as were American bankers. Now everyone knows that Reddy was right. As one Indian banker explained, regarding what happened in the United States: "It was perpetuated by greedy bankers, whether investment bankers or commercial bankers. The greed to make money is the impression it has made here." (Nocera, 2008).

Sub-Lesson: Credit Rating Agencies

There are three major credit-rating agencies: Moody's, Standard & Poors, and Fitch Ratings. All have been accused of being overly generous in how they rated the securities that consisted of bundled, low-quality mortgages. The big question that has arisen is whether these firms assigned very good ratings (AAA) because of sheer incompetence or to make more money. By ingratiating themselves with clients, they were able to steer more business to themselves. There

is no question that the firms were able to make considerably more by providing ratings for complex financial securities than for simple bonds. Rating a complex $350 million mortgage pool would generate approximately $250,000 in fees; rating $350 million of municipal bonds would only generate $50,000 in fees. Morgenson (2008a) quotes a managing director at Moody's, a firm that rates the quality of bonds: "These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little of both."

Moody's graded the securities that consisted of Countrywide Financial's mortgages – Countrywide is the largest mortgage lender in the United States. Apparently, the ratings were not high enough and Countrywide complained. One day later, Moody's raised the rating. This happened several times with securities issued by Countrywide.

Morgenson (2008a) provides an interesting example of how unreliable the ratings had become. A pool of residential subprime mortgages was bundled together by Goldman Sachs during the summer of 2006 (it was called GSAMP 2006-S5). The safest part of this, consisting of $165 million in debt received a AAA rating from Moody's and S & P on August 17, 2006. Eight months later, the rating of this security was lowered to Baa; and on December 4, 2007, it was downgraded to junk bond status.

Lesson: Method of Compensation May Encourage Risk Taking

Warren Buffet once said: "in judging whether corporate America is serious about reforming

itself, CEO pay remains the acid test" (Kristof, 2008). It is obvious to all that corporate America has not performed well on this test. The fact that as many as 29% of firms have been backdating options makes it appear that the system of compensation of executives needs an overhaul (Burrows, 2007). According to a Watson Wyatt survey, approximately 90% of institutional investors believe that top executives are *dramatically* overpaid (Kirkland, 2006).

Richard Fuld, CEO of Lehman Brothers, earned approximately half-a-billion dollars between 1993 and 2007. Kristof (2008) observes that Fuld earned about $17,000 an hour to destroy a solid, 158-year old company. A.I.G. Financial Products, a 377-person office based in London, nearly destroyed the mother company, a trillion-dollar firm with approximately 116,000 employees. This small office found a way to make money selling credit default swaps to financial institutions holding very risky collateralized debt obligations. A.I.G. Financial Products made sure that its employees did very well financially; they earned $3.56 billion in the last seven years (Morgenson, 2008b).

One of the big problems at many Wall Street firms was how compensation was determined. Bonuses made up a huge part of how people were compensated. One individual at Merrill Lynch received $350,000 as salary but $35,000,000 as bonus pay. Bonuses were based on short-term profits; this distorted the way incentives work. Employees were encouraged to take huge risks since they were interested in the bonus. Bonuses were based on the earnings for that year. Thus, billions in bonuses were handed out by Merrill Lynch in 2006 when profits hit $7.5 billion. Of course, those profits were only an illusion as they were based on toxic mortgages. After that, the company lost triple that amount; yet the bonuses were not rescinded (Story, 2008). Lucian

Bebchuk, a compensation expert, asserted that "the whole organization was responding to distorted incentives" (Story, 2008).

It is clear that bonuses based on the profits of a particular year played a role in the financial meltdown. Firms are now changing the way bonuses work so that employees have to return them if the profits turn out to be illusory. The money will be kept in escrow accounts and not distributed unless it is clear that the profits are real. E. Stanley O'Neal, former CEO of Merrill Lynch, not only collected millions of dollars in bonuses but was given a package worth about $161 million when he left Merrill Lynch. He did quite well for someone whose claim to fame is that he nearly destroyed Merrill Lynch; it was finally sold to Bank of America.

According to WaMu employees, CEO Kerry K. Killinger, put a huge amount of pressure on employees to lend money to borrowers with little in the way of income or assets. Real estate agents were given fees of thousands of dollars for bringing borrowers to WaMu. WaMu also gave mortgage brokers generous commissions for the riskiest loans since they produced higher fees and resulted in increased compensation for executives. Between 2001 and 2007, Killinger earned approximately $88 million (Goodman and Morgenson, 2008).

Cohan (2008) also sees "Wall Street's bloated and ineffective compensation system" as a key cause of the financial meltdown. Several politicians are examining the way bonuses work in order to make sure that bonuses will not be given to executives of firms that are receiving government assistance. Cohan (2008) feels very strongly that compensation reform in Wall Street is badly needed. He feels that the change of the old system where the big firms (e.g.,

Donaldson, Lufkin, and Jenrette; Merrill Lynch; Morgan Stanley; Goldman Sachs; Lazard; etc.) switched from being a partnership to a public company contributed to the financial debacle. When these firms were partnerships, there was collective liability so the firms were much more cautious. Once they became corporations with common stock, "bankers and traders were encouraged to take short-term risks with shareholder's money." These bankers and traders did not mind taking on more and more risk since their bonuses depended on the annual profits. Put these ingredients together – encourage risk taking, no accountability, and use shareholder's money – and you get a financial meltdown. Siegel (2009) feels that the CEOs deserve most of the blame for the financial crisis. When the major investment banks such as Lehman Brothers and Bear Stearns were partnerships, they were much more conservative since they were risking their own money. Once they became public companies, they did not mind taking on huge amounts of risk since they were no longer risking their own wealth. In effect, they were using other people's money to become super wealthy.

Cohan (2008) feels that compensation, which consumes approximately 50% of generated revenues, is far too high. It is a myth that these high salaries and bonuses are needed to keep good executives from leaving. There was a time that CEOs earned about 30 to 40 times more than the ordinary worker. Recently, that ratio at large companies has been 344 (Kristof, 2008). For those who believe that large bonuses lead to improved performance, research by Dan Ariely indicates the opposite. Bonuses cost the company more and lead to worse performance (Ariely, 2008). The reason given by Ariely is that the stress caused by trying to win the big bonus overwhelms any ability of the bonus to motivate performance.

It appears that the method of compensation used by Wall Street firms was a distorted incentive that did not improve performance. Rather, it encouraged firms to take on huge amount of risk—risk that eventually destroyed many of these firms. Amy Borrus, deputy director at the Council of Institutional Investors, asserts that “poorly structured pay packages encouraged the get-rich-quick mentality and overly risky behavior that helped bring financial markets to their knees and wiped out profits at so many companies” (Morgenson, 2009).

To make matters even worse, the public has learned that Merrill Lynch rushed $4 billion in end-of-year bonuses to top management a few days before the company was taken over by Bank of America. These bonuses were paid out while the company was reporting a fourth quarter loss of more than $15 billion. Clearly, the bonuses are not rewards for a job well done. John Thain, former CEO of Merrill Lynch, argued that "if you don't pay your best people, you will destroy your franchise." The massive losses suffered by Merrill Lynch forced Bank of America to ask for additional billions in bailout money from the government on top of the $25 billion they had already been promised. Thain also agreed to reimburse Bank of American for the $1.2 million renovation of his office a year ago (LA Times, 2009). The renovation included area rugs for $131,000, chairs for $87,000, a $13,000 chandelier, and an antique commode for $35,000 (Erman, 2009). Citigroup was pressured by the Obama administration to cancel a deal to purchase a $50 million new French corporate jet. Citigroup was castigated by the media and called Citiboob by the *New York Post* for this planned purchase. Citigroup has lost billions of dollars, fired 52,000 employees, and received $45 billion in government bailout money, yet they were ready to purchase this luxury for its executives (Keil and Bennett, 2009).

The year 2008 was a time in which Wall Street firms lost billions. The country was surprised to learn that this did not stop these firms from giving out bonuses totaling $18.4 billion – sixth largest amount ever. Apparently, bonuses are also doled out for a job poorly done. President Obama declared these bonuses "shameful" and "the height of irresponsibility." Vice President Biden stated : "I'd like to throw these guys in the brig; They're thinking the same old thing that got us here, greed. They're thinking, 'Take care of me'" (Stolberg and Labaton, 2009).

What has become clear to the public is that Wall Street just does not get it. The public and the media see the Wall Street executives who are indifferent to what they caused. They still feel that they deserve enormous amounts of money even if their firms have shed thousands of jobs and have nearly destroyed the financial system. Ira Kay, an executive consultant with Watson Wyatt, feels that you can make a strong case that the Wall Street culture (some refer it to the "eat what you kill" mentality) as well as the bonuses that resulted from this kind of selfish culture have contributed greatly to the current financial meltdown (Nocera, 2009b).

There is no question that executive compensation is going to be scrutinized very carefully in the future, even by Boards that were far too chummy with CEOs. There is talk of passing legislation that will force CEOs to return past pay — this is known as a "clawback"—
in cases where compensation was based on profits that turned out to be illusory. Frederick E. Rowe, a founder of Investors for Director Accountability, feels that "there is a fine line that separates fair compensation from stealing from shareholders. When managements ignore that line or can't see it, then hell, yes, they should be required to give the money back" (Morgenson, 2009). There is even talk of "clawing back" executives' pensions in cases where the profit

earned by the firm turned out to be imaginary.

Lesson: Models Have Only Limited Value

Models are representations of reality. They will not work if conditions have changed dramatically. They certainly will not work if compensation is tied to risk taking and executives insist that employees take risks to enrich themselves. As noted above, executives were doing everything possible to show stellar performance – even if it meant taking on huge amounts of risk – since they wanted a fat yearly bonus. Whenever there are conflicts of interest, poor decisions are likely to be made. Models rely on interpretation by people. If the employees interpreting the model are afraid of losing their jobs, they will construe the models in a way that pleases top management.

As noted above, Fannie Mae, decided to expand into riskier mortgages in the year 2000. They believed that their sophisticated models would allow them to purchase riskier mortgages and that these computer models would protect them from the increased risk. After all, Fannie Mae would charge higher fees for risky mortgages. The mortgages though became super risky because of very low down payments and unverified income on the part of the borrower. It is doubtful that any model could anticipate that millions of homeowners would find it easy to walk away from their mortgage. In the past, relatively few people defaulted on a mortgage because they had to make a substantial down payment (Duhigg, 2008).

Lewis and Einhorn (2009) feel that the rating agencies did not measure risk properly. American financial institutions took on a great deal more risk without having to face a downgrading of their securities. This was probably due to the fact that the credit rating agencies were making money on the risky securities being created by these very same financial institutions. Companies such as AIG, Fannie Mae, Freddie Mac, GE, and MBIA which guarantees municipal bonds kept their AAA rating for a very long time. Lewis and Einhorn (2009) make the point that MBIA deserved its AAA rating in 1990 when it insured municipal bonds and had $931 million in equity and $200 million of debt. By the year 2006, MBIA was insuring CDOs (collateralized debt obligations) which are extremely risky; the company had $26.2 billion in debt and only $7.2 billion in equity. It kept its AAA rating for quite a while until it was obvious to everyone that MBIA was no longer a secure firm. The models that were being used by the credit rating agencies may have worked quite well. However, no one wanted to kill the goose that was producing so much profit for the credit rating agencies. Indeed, the agencies, as noted above, were quite pleased with all the risky securities they were paid to evaluate.

Back in 2004, as noted above, the investment banks wanted the S.E.C. to give them an exemption from a regulation that limited the amount of debt – known as the net capital rule – they could have on their balance sheets. By increasing the amount of debt, they would be able to invest in the "opaque world of mortgage-backed securities" and credit default swaps (CDSs). The S.E.C. agreed this change and decided to allow the investment banks to monitor their own riskiness by using computer models to analyze the riskiness of various securities (Labaton, 2008). One individual was opposed to the changes and said the computer models would not work in periods of "severe market turbulence." He pointed out that computer models did not

protect Long-Term Capital Management from collapse (Labaton, 2008). Of course, no one listened to him.

One measure of risk that was very popular with the financial engineers was VaR (Value at Risk). This is a short-term measure of risk (daily, weekly, or for a few weeks) expressed in dollars and is one number and is based on the normal distribution. A weekly VaR of $100 million indicates that, for that week, there is a 99% probability that the portfolio will not lose more than $100 million. Of course, this is based on what has happened in the past. Alan Greenspan noted the following when trying to explain what went wrong during the financial meltdown:

> The whole intellectual edifice, however, collapsed in the summer of last year because the data input into the risk-management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment (Nocera, 2009a).

The problem with VaR and similar measures is that it ignores what can happen 1% of the time. Taleb (2007) considers VaR a dishonest measure since it does not measure risks that come out of nowhere, the so called “black swan.” It provides a false sense of security because over the long run, things that have low probabilities of occurrence do happen. Indeed, Long Term Capital

Management collapsed because of a black swan, unexpected financial crises in Asia and Russia (Nocera, 2009a).

Conclusion

Phelps (2009) observes:

> Whether in Enron's creative accounting, the packaging of high-risk subprime mortgages as top-grade collaterized debt obligations, or Bernard Madoff's $50 billion scam operation, the recent riot of capitalist irresponsibility has shattered the fantasy that the free market, left to its own devices, will produce rationality and prosperity."

The key lessons one can learn from the global financial crisis of 2008 are the following:

Some *self-interest* is good. Capitalism requires it and human beings are programmed that way. However, voracious self-interest with total disregard for everyone else is not good for society.

Too much *regulation* may be a bad thing. It stifles innovation and is not good for business or society. On the other hand, too little regulation is even more dangerous for society and business. China is discovering this with their recent problem with tainted milk which killed several children. Apparently, executives at several dairy companies sold dairy products adulterated with melamine, a toxic chemical, in order to make the protein count appear higher than it actually

was. One executive, who has been sentenced to death, was convicted of selling 600 tons of "protein powder" contaminated with melamine to dairy firms (Barboza, 2009).

The poor conditions of the Peanut Corporation of America plant in Blakely, Georgia which resulted in a salmonella outbreak also demonstrated what can happen when there is too little regulation. ConAgra, manufacturer of Peter Pan peanut butter, had similar problems and upgraded its safety procedures after a salmonella outbreak in 2007. Government officials admitted that there were not enough agents (60) to monitor thousands of food businesses. It is clear that the plant inspectors missed many serious and chronic problems such as a leaky roof in the Blakely plant (Moss, 2009).

Coming up with the right amount of regulation is not impossible. What is needed is sufficient regulation to discourage huge risk taking but enough to encourage innovation (Knowledge@Wharton, 2009).

Incentives are an effective way of motivating people. However, bonuses may not be the appropriate kind of incentive for executives. In fact, bonuses can help destroy firms if they encourage executives to focus on short-term profits rather than the long-term health of a company.

Mathematical models might provide some insights but ultimately it is people who have to interpret them. They can be used to justify almost anything and can cause as much harm as good.

The global financial crisis would not have occurred if executives were truly ethical. There is no question that lack of *ethics* played a significant role in the meltdown. A large number of people knew that the mortgages they were dealing with were toxic. It does not take a great financial expert to know that mortgages with no down payments given to people with no income is extremely foolhardy. The excuse that they believed that housing prices would continue to keep going up (at one point houses were doubling in value every six or seven years) is not credible and indeed it is not even a legitimate justification for this behavior. The truth is that as long as there was money to be made, virtually no one said anything. To hide how risky these toxic mortgages were, they turned them into securities. To make matters worse, mortgage brokers were encouraged to do everything possible to get people to take out mortgages. The rating agencies were making money on rating these securities so they did not do their job. All the parties figured someone else would end up holding the bag.

One thing is clear: free markets do not work well unless there is accountability, responsibility, ethics, and transparency. Predatory capitalism that disregards the concern for others and is based purely on self-interest may even be more dangerous than communism.

References

Alvey, James E. (1999). Why spirituality deserves a central place in liberal education. *Journal of Markets and Morality*, 2(1), Spring, 53-73.

Andrews, Edmund L. (2008, October 24). Greenspan concedes error on regulation. *New York Times*, B1, B6.

Ariely, Dan (2008, November 20) What's the value of a big bonus? *New York Times*, OP-ED, A43.

Barboza, David (2009, January 23). China plans to execute 2 in scandal over milk. *New York Times*, A5.

Becker, Jo, Stolberg, Sheryl G. and Labaton, S. (2008, December 21). White House philosophy stoked mortgage bonfire. *New York Times*, 1, 36-37.

Burrows, Peter (2007, January 15). He's making hay as CEOs squirm. *Business Week*, 64-65.

Cohan, William D. (2008, November 16). Our risk, Wall Street's reward. *New York Times*, Week in Review, 13.

Cohen, Patricia (2007, July 11). In economics departments, a growing will to debate fundamental assumptions. *New York Times*, B6.

Cox, Christopher (2008, October 19). Swapping secrecy for transparency. *New York Times*, Week in Review, 12.

Curry, Timothy and Shibut, L. (2000). The cost of the savings and loan crisis: Truth and consequences. *FDIC Banking Review, 13(2).* Retrieved December 29, 2008 from http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf.

Duhigg, Charles (2008, October 5). Pressured to take more risk, Fannie reached a tipping point. *New York Times*, 1, 34.

Erman, Boyd (2009, January 23). Big bonuses, costly commodes: Thain out at B of A. *Globeandmail.com*. Retrieved January 28, 2009 from http://www.theglobeandmail.com/servlet/story/LAC.20090123.RTHAIN23/TPStory/Business

Friedman, Thomas L. (2008, December 17). The great unraveling. *New York Times*, OP-ED, A39.

Gandel, Stephen (2008, December 17). The Mdoff fraud: How culpable were the auditors? Time, Retrieved December 29, 2008 from http://www.time.com/time/printout/0,8816,1867092,00.html#

Goodman, Peter S. (2008, October 9). Taking a hard look at a Greenspan legacy. *New York Times*, A1, A29.

Goodman, Peter S. and Morgenson, G. (2008, December 28). By saying yes, WaMu built empire on shaky loans. *New York Times*, 1, 22.

Howard, George S. (1997). The tragedy of maximization. *Ecopsychology Online*. October, Retrieved June 25, 2007 from http://ecopsychology.athabascau.ca/1097/index.htm#politics

Keil, Jennifer Gould and Bennett, C. (2009, January 27). Citigroup cancels plans to buy $50m jet. New York Post. Retrieved January 28, 2009 from http://www.nypost.com/seven/01272009/news/nationalnews/citigroup_cancels_plans_to_buy_50m_jet_152270.htm

Kirkland, Rik (2006, June 30). The real CEO pay problem. *Fortune*. Retrieved July 29, 2008 from http://money.cnn.com/magazines/fortune/fortune_archive/2006/07/10/8380799/index.htm

Knowledge@Wharton (2009, January 21). Getting It Right: Making the Most of an Opportunity to Update Market Regulation. Retrieved January 22, 2009 from http://knowledge.wharton.upenn.edu/article.cfm?articleid=2145

Kristof, Nicholas (2008, September 18). Need a job? $17,000 an hour. No success required. *New York Times*, OP-ED, A29.

Kroft, Steve (2008, October 26). The bet that blew up Wall Street. *60 Minutes*, retrieved January 4, 2008 from http://www.cbsnews.com/stories/2008/10/26/60minutes/main4546199.shtml

Labaton, Stephen (2008, October 3). Agency's '04 rule let banks pile up new debt and risk. *New York Times*, A1, A23.

Landy, Heather (2008, November 15). Credit default swaps oversight nears. *Washington Post*, D03.

Lewis, M. and Einhorn, D. (2009, January 4). The end of the financial world as we know it. *New York Times.* Week in Review, 9-10.

Lichtblau, Eric (2008, December 25). Federal Cases of Stock Fraud Drop Sharply. *New York Times*, A1.

Lipton, Eric and Hernandez, R. (2008, December 14). A champion of Wall Street reaps benefits. *New York Times*, 1, 36.

Lorsch, Jay W., Berlowitz, L., and Zelleke, A., Eds. (2005). *Restoring trust in American business.* Cambridge, MA: MIT Press.

Los Angeles Times (2009, January 27). John Thain defends Merrill Lynch bonuses amid Bank of America Takeover. *latimes.com*. Retrieved January 28, 2009 from http://www.latimes.com/business/la-fi-thain27-2009jan27,0,476991.story

Lowenstein, Roger (2008, September 7). Long-Term Capital Management: It's a short term memory. *International Herald Tribune*. Retrieved December 29, 2008 from http://www.iht.com/articles/2008/09/07/business/07ltcm.php

Monaghan, Peter (2003, January 24). Taking on 'rational man.' *Chronicle of Higher Education*, A12-A15.

Morgenson, Gretchen (2008a, December 7). Debt watchdogs: Tamed or caught napping. *New York Times*, 1, 40.

Morgenson, Gretchen (2008b, September 28). Behind insurer's crisis, blind eye to a web of risk. *New York Times*, 1, 28.

Morgenson, Gretchen (2009, February 22). After huge losses, a move to reclaim executives' pay. Sunday Business, *New York Times*, 1, 7.

Moss, Michael (2009, February 9). Peanut case shows holes in food safety net. *New York Times*, A1, A12.

Nocera, Joe (2008, December 20). How India avoided a crisis. *New York Times*, B1, B8.

Nocera, Joe (2009a, January 4). Risk Mismanagement. *New York Times Magazine*, 23-50.

Nocera, Joe (2009b, January 31). Getting theirs: It's not the bonus money. It's the principle. *New York Times*, Business Day, 1, 4.

Norris, Floyd (2009, February 27). Failing upward at the Fed. *New York Times*, Business Day, B1, B4.

Pearlstein, Steve (2007, March 14). No money down falls flat. *Washington Post*, D01.

Phelps, Christopher (2009, February 13). Beyond economic revival: Which New Deal approaches are worth emulating? *Chronicle Review*, B10-B12.

Philips, Mathew (2008, October 6) The monster that ate Wall Street. *Newsweek*. Retrieved on January 4, 2009 from http://www.newsweek.com/id/161199

Pitelis, Christos (2002). On economics and business ethics. *Business Ethics: A European Review,*11(2), 111-118.

Robinson, Joan (2007, July 3). Morality and economics. Commencement Address. Retrieved July 9, 2007 from *Economist's View* http://economistsview.typepad.com/economistsview/2007/07/morality-and-ec.html

Roosevelt, Franklin D. (1937). Second Inaugural Address. Retrieved October 25, 2008 from Bartleby.com http://www.bartleby.com/124/pres50.html

Satow, Julie (2008, September 22). Default swaps may be next in credit crisis. New York Sun, http://www.nysun.com/business/default-swaps-may-be-next-in-credit-crisis/86312/

Siegel, Jeremy (2009, January 21). Lesson one: What really lies behind the financial crisis. *Knowledge@Wharton*. Retrieved January 22, 2009 from: http://knowledge.wharton.upenn.edu/article/2148.cfm

Skidelsky, Robert (2008, December 14). The remedist. *New York Times Magazine*, 21-22.

Stolberg, Sheryl Gay and Labaton, S. (2009, January 30). Banker bonuses are 'shameful,' Obama declares. *New York Times*, A1, A20.

Story, Louise (2008, December 18). On Wall Street, bonuses, not profits, were real. *New York Times*, A1, A35.

Suskind, Ron (2008, September 25). The crisis last time. *New York Times*, OP-ED, A29.

Taleb, Nassim N. (2007). *The black swan: The impact of the highly improbable*. New York: Random House.