WAS THE 2008 FINANCIAL CRISIS CAUSED BY A LACK OF CORPORATE ETHICS?

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ABSTRACT

During the second half of 2008, the United States financial markets, and eventually all major world markets, were devastated by the aftermath of unethical lending practices by major lending institutions. These bad loans were made at the height of a real estate bubble in the United States. Aggressive lenders engaged in loans called "sub-prime mortgages." These mortgages were extremely high risk and most of them violated traditional underwriting standards for the industry. Prudence and ethics were pushed aside as greed overcame good judgment among mortgage lenders nationwide. The problem was exacerbated by the packaging, and leveraging, of these loans by Wall Street financial companies. These companies leveraged these bad loans, and sold them to unsuspecting buyers as bundled investments in the secondary markets. When the overheated United States real estate market finally began a severe and protracted correction of fair market values due to these bad sub-prime loans made to questionable borrowers, not only did the real estate markets collapse but it resulted in a domino effect causing the collapse of major banks and a precipitous and protracted market drop in stock values, financial companies, insurers, and eventually the biggest financial crisis since the great depression. This paper will review the 2008 collapse, and evaluate the questionable practices among the various corporate and financial participants that caused a worldwide collapse of shareholder values. This paper will also explore and review the United States government's various attempts to solve this great crisis including what proper ethical and legal safeguards are being considered to prevent a repeat of this disaster in the future.

JEL: M00, M14, M48

INTRODUCTION

Who is to blame for the current financial crisis that has led to a mortgage and stock market meltdown that incoming President Elect Obama has called "the greatest crisis since the great depression"? Many feel that the financial services industry is to blame because it has consistently tried to defy gravity by using debt, securitization and proprietary trading to boost fee income and profits. Investors, hungry for yield have willingly gone along with the financial services industry. Due to this collaboration, this process has turned investment banks into debt machines that trade heavily on their own accounts. Goldman Sachs used approximately $40 billion of equity as the foundation for $1.1 trillion of assets. At Merrill Lynch, the most leveraged, approximately $1 trillion of assets teetered on approximately $30 billion of equity. In rising markets, this type of strategy creates stellar returns on equity. However, history tells that when markets are in peril, a small fall in asset values can completely wipe out shareholder equity. Many feel that the financial services industry, that had promised miracles, did nothing more than seduce the greedy and bring destruction to not only the United States economy but to the global world markets as well. The paper is organized into five parts. The first part discusses the events leading up to the mortgage and stock market meltdown. The second part discusses the main causes of the bank failures and subsequent bailouts. The third part discusses the now congressionally approved auto company bailouts. The fourth part discusses possible suggested remedies. Finally, the conclusion

presents a summary of the paper and answers the hypothesis of whether the 2008 financial crisis was indeed caused by a lack of corporate ethics.

LITERATURE REVIEW

J. E. Stiglitz in his essay in 2003 entitled Ethics, Market and Government Failure, and Globalization looked at how ethical aspects of globalization proceeded in recent years. In particular, Stiglitz argued that it was socially unjust if the more affluent benefit at the expense of someone who is poorer and to view negative redistributions as ethically wrong. Stiglitz goes on to posit that the United States Treasury and the International Monetary Fund have long well overstepped these bounds. Stiglitz states that they have put forward as economic advice, policies which advantage one group at the expense of others. Stiglitz points out that some economists have questioned whether ethics has much of anything to do with economics. He further points out that when there are market failures, however, individuals in the pursuit of their own interests may not pursue general interests. Discussing ethical issues, Stiglitz states there is a fine line between ordinary incentives and broader ethical issues. In the United States, the corporate accounting, and banking scandals, in each of which, individuals were simply acting in ways which reflected their own interests, and most of which were at the time totally legal, raised serious ethical issues. Stiglitz goes on to point out that "CEO's and other executives deliberately took advantage of their positions of trust to enrich themselves at the expense of those they were supposed to serve." Does this scenario sound familiar?

Z. Jun Lin, (2000) analyzed the impact of the Asian financial crisis on the Chinese economy and the preventive measures adopted by the Chinese Government to curb an economic recession in China. Although currencies were substantially devaluated and banking systems collapsed in most Asian countries, China escaped from the disastrous scenarios affecting most Asian countries Lin points out that China suffered a shaky banking system. There were enormous amounts of troublesome loans in China's banking system derived from frequent interventions of credit policies by government authorities. The banks' exposure to bad loans was substantially high. He further points out that according to some estimates, the portion of "risky loans" in Chinese state-owned banks stood at a level well above the acceptable ceiling recognized by international credit-rating institutions. This is probably why the Chinese government is so worried about the enormous value of United States bonds purchased and whether their investment is safe.

Laurids S. Lauridsen (1998) examined the financial crisis in Thailand which was found to be a private sector failure" and expressed itself mainly in careless lending/borrowing practices and the accumulation of nonperforming loans. When the economy showed signs of weakening, "hot money" flowed in and covered the deficit but also led to careless investments. This financial liberalization resulted in a miscalculation and political instability, indecisiveness and mismanagement at the political and administrative level and contributed to a financial meltdown in Thailand.

Inder P. Khera, (2001) in discussing ethics did a study on ethical business practices of businesses, officials and politicians in the East compared to the Western world. He found that although most consider Eastern Third World countries pervasively corrupt while Westerners view themselves as mostly uncorrupt, realities turned out to be quite different. Khera found that advanced countries often take a stereotypical view of the governments and institutions in developing countries of Asia, Africa, and Latin America as being corrupt, uninformed, incompetent, and just plain ignorant, while their views of their own businesses, governments, institutions, etc., are those of hardworking knowledgeable, ethical well-governed, efficient, productive , etc. Khera goes on the state that in the 1997 Asian financial crisis, Times columnist A. M. Rosenthal wrote that Asian leaders, bankers and business executives worked in a tight partnership to drive their countries into chaos through institutionalized corruption, nepotism and crony capitalism. Khera's premise is that the reality of the way things really are as reported by Time magazine

in 2000 is that there exists a working relationship between United States politicians and "their commercial henchmen" He goes on to state that political contributions and extensive spending on lobbying net rich American firms billions of dollars in tax relief, government bailouts from bad decisions, ability to pay lower-than-market-rate wages, immunity from certain laws, and the ability to kill or change legislation they do not like. Khera alludes to a study by sociologist Emiti Etzione who found that between 1975 and 1985, two-thirds of the Fortune 500 firms had been convicted of serious crimes ranging from price fixing to illegal dumping of hazardous waste. Khera's research further found that although recent financial scandals in the United States have typically occurred in commodity trading, the Wall Street (Ivan Bosky, Michael Milken) and defense contracts, no industry is immune to abuses. He further points out that Melvyn Weiss, the king of class-action suites has won huge judgments and settlements from such giants as Prudential Insurance Company, Washington Public Power supply, Rexall Sundown, Tyco, Windmere Holdings, Sunbeam, Aviation Sales, National Finance Corp., Metropolitan Life Insurance, and many more.

Therefore, this latest financial ethical crisis is not the first time this has occurred nor will it be the last time unless the proper government regulations are put in place.

WHAT WENT WRONG

Alan Greenspan, former Chairman of the Federal Reserve, said in 2005, "that increasingly complex financial instruments have contributed to the development of a far more efficient, flexible, and hence resilient financial system than the one that existed just a quarter-century ago." Tell that to Bear Stearns, Wall Street's fifth largest investment bank, who became the most spectacular corporate casualty due to the current financial crisis. Financial experts have stated that the demise of Bear Stearns in March 2008 was the inevitable consequence of the laissez-faire philosophy that allowed financial institutions to wrongfully innovate and spread almost unchecked without any proper controls. This in turn, created a complex, interdependent system prone to conflicts of interest, fraudulent practices, and the eventual sale of sub-prime mortgages backed by unqualified mortgagors. Spurred on by short term gains, bankers and fund managers stand accused of pocketing enormous bonuses with no thought to the long-term consequences of their actions. The gambling by these bankers and fund managers was fed by the knowledge that if disaster struck, someone else, i.e. borrowers, investors, taxpayers, would end up bearing the lion's share of the losses. The banks' course was made possible by cheap money, facilitated in turn by low consumer-price inflation.

Although in more regulated times, credit controls or the gold standard, restricted the creation of credit. As a prelude to this current financial crisis, central banks in effect conspired with local banks to enhance their philosophy to earn higher and higher fees, resulting in a glut of liquidity and a thirst for yield that led eventually to the ill-fated boom in American sub-prime mortgages. This tendency of bankers and financial managers to accept unnecessary risk is accentuated by the fact that their financial assets' have a habit of growing during booms. By hedging their extra assets as collateral, these same individuals can put them to work and borrow even more. Tobias Adrian, of the Federal Reserve Bank of New York, and Hyun Song Shin, a Professor of economics at Princeton University, posit that since the 1970s, debts have grown faster than assets during booms. This pro-cyclical leverage can feed on itself. If financial groups use the borrowed money to buy more of the sorts of securities they lodged as collateral, then the prices of those securities will go up. That, in turn, enables them to accrue even more debt to buy more securities. Unfortunately, sooner or later, the music stops. And when it does stop, the very mechanisms that create abundant credit will also destroy that credit. Most securities attract buyers when the price falls. But this is not necessarily so because financial intermediaries need to limit their leverage and in a falling market, they sell assets. That lowers the prices of securities, which puts further strain on balance sheets leading to further sales. Existing rules on capital adequacy require banks to put some capital aside for each asset. If the market leads to losses, the chances are they will have enough capital to cope. Yet this rule sets up a

perverse incentive to create structures free of the capital burden, such as credits that last 364 days, and hence do not count as "permanent". The hundreds of billions of dollars in the shadow banking system, the notorious SIVs and conduits that have caused the banks so much pain have been warehoused there to get around the rules. Spain's banking regulator prudently said that such vehicles could be created, but only if the banks put capital aside. So far, that country has escaped the damage seen elsewhere. When reformed capital-adequacy rules are introduced, this is an area that will need to be monitored rigorously. The financial industry is likely to stagnate or shrink in the next few years. That is partly because the last phase of its growth was founded on unsustainable leverage, and partly because the value of the underlying equities and bonds is unlikely to grow as it did in the 1980s and 1990s. (The Economist. London: Mar 22, 2008. Vol. 386, Issue 8572; page 92)

INDYMAC: THINKING BEYOND FORECLOSURE

Diane Smith could have been another foreclosure statistic. The 56-year-old mother of two refinanced her Los Angeles home in 2006 to pay for a kitchen remodeling. However, Smith, a small business owner, found herself in trouble earlier this year after the teaser rate on her adjustable-rate mortgage expired and banks began lowering spending limits on her credit cards. Smith’s monthly mortgage payment jumped spectacularly and she could not pay it. That's when her mortgage lender, IndyMac Federal Bank, made her an offer she couldn't refuse. In September, the bank knocked down the rate on her loan to 4.75%, slashing her monthly payments from $6,000 to $4,050. The bank also provided counseling to help Smith manage her household expenses. Smith is one of more than 3,000 borrowers who have signed on to a fast-track loan modification program launched by IndyMac, the insolvent California lender seized by the feds in July. Officials from the Federal Deposit Insurance Corp. have moved quickly to tackle the 60,000 delinquent mortgages in IndyMac's portfolio of 742,000 home loans. In late August, letters went out to 7,500 distressed borrowers, offering new terms.

The FDIC says those taking part have seen their monthly payments lowered by $430 per month on average. FDIC Chairwoman Sheila C. Bair is hoping the IndyMac initiative will provide a blueprint for the rest of the industry. Lenders have been under fire from politicians and consumer advocates for not doing enough to stave off a wave of foreclosures: Filings were up 82% in the first half of the year. The FDIC and investors will end up footing the bill for IndyMac's loan modification program. If the plan succeeds, it will keep families like Smith in their homes. In addition, could help arrest the rot in the complex, mortgage-backed securities that precipitated the worldwide financial meltdown. "Theirs is the first systematic effort to really simplify the loan modification process," That is the solution to the mortgage crisis." says Austin King, director of the financial justice unit at Acorn, a community advocacy group. Like it or not, more lenders may be compelled to negotiate new terms with delinquent borrowers. On Oct. 6, Bank of America announced it had reached a legal settlement with authorities in 11 states that had been looking into allegations of predatory lending practices at Countrywide Financial, the mortgage lender it acquired earlier this year. As part of that deal, Bank of America has committed to modifying loans for nearly 400,000 customers. (Source: Business Week. New York: October 20, 2008)

MELTDOWN 101: WHY DID THE AIG BAILOUT GET BIGGER?

According to the (AP), the bailout of insurance giant American International Group (AIG) is a $150 billion gamble. That’s the size of the newly enlarged financial lifeline the U.S. government threw the tottering insurance giant, expanding an aid package that’s gradually grown since it began as an $85 billion loan in September 2008. The history of this bailout is that back on September 16, 2008, the Federal Reserve initially provided AIG with a $85 billion loan, in return for a nearly 80% ownership stake. On October 8, 2008, the Fed followed up with another $37.8 billion loan. Then on October 31, 2008, AIG was allowed access to yet another $20.0 billion through the Fed’s “commercial paper” program. That’s

where the Fed buys mounds of short-term debt from the companies, which often used the money for crucial day-to-day expenses, such as payroll and supplies. So, even with the original $85 billion lifeline, AIG continued to have problems as the country's overall financial and credit conditions worsened. AIG was saddled with risky mortgage-related securities that had fallen sharply in value and continued to deteriorate after the initial bailout. Shortly thereafter, AIG reported a massive third- quarter hit. It lost $24.47 billion, or $9.95 a share, compared to a profit of $3.09 billion, or $1.19 per share, a year ago. "This is the largest quarterly loss we've ever reported," Chief Financial Officer David Herzog told investors. In addition, the Treasury Department is now stepping in with $40 billion, which is coming from the $700 billion financial bailout package enacted in November. It marked the first time any of that bailout money has gone to any company other than a bank. In addition, this new arrangement replaced the $37.8 billion Fed loan to AIG with a $52.5 billion aid package. So why is it important to keep AIG afloat? The answer is simple; AIG is a collossus with operations in more than 130 countries. It is so interconnected with other financial firms that its problems have a jolting ripple effect in both the United States as well as abroad. In exchange for the money, Neel Kashkari, the Treasury Department official who is serving as the interim head of the $700 billion financial bailout program has said, that "AIG must comply with stringent limitations on executive compensation for its top executives, golden parachutes, its bonus pool, corporate expenses and lobbying." (Source: Washington AP-November 10, 2008)

Citibank Bailout: $300 Billion Doesn't Sound Like a Lot Anymore

The Wall Street Journal reports in November that Citibank has become the latest recipient of a government bailout, this time to the tune of $300 billion, or thereabouts. Somehow, $300 billion doesn't sound like a lot of money anymore. In late November, the Treasury Department was talking about a $500 to $700 billion stimulus package that will be on President Obama's desk, ready to sign on inauguration day. This is a new record – a $trillion in government commitments in a single day. The Treasury Department has also agreed to inject an additional $20 billion in capital into Citigroup under terms of the deal hashed out between the bank, the Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corp. In addition to the capital, Citigroup will have an extremely unusual arrangement in which the government agrees to backstop a roughly $300 billion pool of assets, containing mortgage-backed securities among other things. Citigroup must absorb the first $37 to 40 billion in losses from these assets. If losses extend beyond that level, Treasury will absorb the next $5 billion in losses, followed by the FDIC taking on the next $10 billion in losses. Any losses on these assets beyond that level would be taken by the Fed. (Source: Wall Street Journal-November 24, 2008)

Are U.S. Auto Companies Next in Line for a Bailout?

In late November and the first week of December 2008, General Motors Corp., Ford Motor Co., and Chrysler LLC have been pressing the government for financial assistance. First, they came hat in hand requesting a $25 billion loan and now in December 2008, that request has increased to almost $40 billion. This request is on top of the $25 billion in loans Congress passed in September to help retool auto plants to build more fuel-efficient vehicles. (Source Washington AP-November 10, 2008)

POSSIBLE REMEDIES

Bankers have long argued that there is no one-size-fits-all solution to the mortgage mess. Loan workouts, they say, must be done on a case-by-case basis. Yet the IndyMac program was designed around a simple formula: borrowers' mortgage payments should amount to no more than 38% of their gross income. "The key is to make the new loans affordable," says John Bovenzi, the senior FDIC executive now serving as CEO at IndyMac. Bovenzi also knows how to tailor his pitch. At banks, the traditional approach is to send delinquent borrowers a form letter asking them to call the bank to discuss their payment problems. But

instead of using regular mail, IndyMac sent out its letters in overnight delivery packages, which had to be signed for (to prevent the contents from being mistaken for junk mail). What those envelopes contained was, by bank standards, a remarkably straightforward piece of communication: a letter stating, "We want to help you stay in your home," at the top, accompanied by a dollar figure, the new, lower monthly payment being offered. All the recipient had to do was sign a couple of forms and send them back in a prepaid return envelope. IndyMac's new management team readily acknowledges that not all distressed borrowers can be helped. As many as one-third just don't have the income to support even reduced payments. One such case involved a Nevada woman who wanted to relocate after her husband, the family's sole breadwinner, was incapacitated by a stroke. In what's known as a "cash for keys" offer, IndyMac paid her $5,000 to surrender her home. As word of its program has gotten around, IndyMac has been deluged with inquiries from borrowers looking to refinance on better terms, though it's debatable whether many of them are actually in need of assistance. One Washington D.C. woman telephoned senior FDIC officials as well as the top four IndyMac executives to badger them about lowering payments on an investment property.

The bank postponed a scheduled foreclosure but hasn't agreed to renegotiate. "This is like triage after a train crash," says IndyMac spokesman Evan Wagner. "You take care of the worst cases first." Bovenzi has plenty of experience in dealing with bad loans. An FDIC veteran, he worked at the agency during the savings and loan crisis of the late '80s and early '90s. One of the key lessons from that era: Debt workouts can pay off for lenders as well as for borrowers. Chairwoman Bair, in a Sept. 17 speech to Congress, noted that the FDIC's recovery rate on nonperforming loans averages just 32% of the loan's value. If the loan is current, the agency gets 87%. It's too early to judge whether the IndyMac program will succeed. There are studies that show many loan modifications offer at best, only temporary reprieves. Many borrowers will continue to fall behind on payments. Moreover, there is no guarantee that whoever eventually buys IndyMac, will carry on with the program. Already several would-be buyers have visited its Pasadena headquarters to pore over the books. In the meantime, Bovenzi, who once headed the Liquidation Department unit of the FDIC, has been busy dumping assets. First to go were the season tickets to Los Angeles Dodgers games used to entertain corporate clients. A company-owned Porsche went for $65,000 on AutoTrader.com in August. Next on the list: are the paintings hanging on the walls. On the downside, Valparaiso University law professor Alan White looked at 4,344 renegotiated subprime loans and found that only half of the modified loans resulted in lower payments. In many cases, the amount owed actually rose as missed payments and late fees were added to the loan's principal. His conclusion: "The subprime crisis will be worked out only over a period of many years." (Source: Business Week, New York: October 20, 2008)

U.S. Tackles Consumer Debt Market

The Los Angeles Times reports that the federal government’s new $800 billion initiative to revive the nation’s credit markets and reverse the deepening economic crisis propels the government into risky territory-the uncertain world of credit cards, student loans, auto loans and cash-strapped small businesses. Most of the money in the plan is aimed at making home loans cheaper and more readily available. To that end, the Fed plans to buy as much as $600 billion in debt and mortgage-backed securities held or issued by government-sponsored lenders such as Fannie Mae, Freddie Mac and Ginnie Mae and the Federal Home Loan Banks. In addition, the Fed will commit as much as $200 billion to help loosen lending for consumer goods, including everything people can buy with their credit cards. This is intended to make it easier for ordinary Americans to get credit. (Source: Los Angeles Times: November 26, 2008)

Treasury Weighs Plan to Lower Mortgage Rates

Under this proposal according to Scott Talbott, Vice President of the Financial Services roundtable, the Treasury Department would seek to lower the rate on a 30-year mortgage to 4.5%. That's about 1 percentage point below the current rate in December of 5.6%. The Treasury Department would accomplish this by purchasing mortgage-backed securities from Fannie Mae and Freddie Mac. Although the details are in flux, the program would be similar to the effort the Federal Reserve announced at the end of November to purchase up to $500 billion of mortgage-backed securities from the two mortgage giants. Fannie Mae and Freddie Mac, which were seized by federal regulators in September, own or guarantee about half of the $11.5 trillion in U.S. outstanding home loan debt. (Source: Washington Associated Press, L.A. Times 12/4/08)

N.Y. Prosecutor Picked to Oversee Bailout

The Washington Post has reported that the White House has nominated Neil M. Barofsky, an Assistant U.S. Attorney for the Southern District of New York to oversee the $700 billion bailout program. Mr. Barofsky has spent his entire career as a federal prosecutor specializing in $multibillion accounting frauds. (Source: Washington Post: November 15, 2008)

CONCLUSION

This financial crisis has been called by many, including President-Elect Obama, "the biggest financial crisis since the great depression". The bailout started out as a $700 billion bailout and is now expected to reach almost $2 trillion. Since experts believe that it could take up to two years before the financial markets stabilize, with the massive amount of bailout funds to be expended, it is important to monitor the bailout, which the government is attempting to do with the appointment of a federal prosecutor as the chief watchdog. The incoming Obama administration has stated that it intends to initiate creative new fiscal policies designed to revive and stimulate the domestic markets and the overall U.S. economy. This together with massive new spending programs, which were initially designed to rebuild the national infrastructure, should also result in increased employment to get people who have lost their jobs, back to work. It is the new administration's goal to restore faith in government and in the financial markets by immediately initiating investigations into past unethical and questionable financial practices by greedy corporations who many believe are responsible for the current financial crisis that led to the mortgage and stock market meltdown. Hopefully things will not get worse prior to the new administration's financial team taking over on January 20, 2009.

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