

The financial services industry and society

The role of incentives/punishments, moral hazard, and conflicts of interests in the 2008 financial crisis

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Abstract

Purpose – This paper aims to present an analysis of the role of financial incentives, moral hazard and conflicts of interests leading up to the 2008 financial crisis.

Design/methodology/approach – The study's analysis has identified common structural flaws throughout the securitization food chain. These structural flaws include inappropriate incentives, the absence of punishment, moral hazard and conflicts of interest. This research sees the full impact of these structural flaws when considering their co-occurrence throughout the financial system. The authors address systemic defects in the securitization food chain and examine the inter-relationships among homeowners, mortgage originators, investment banks and investors. The authors also address the role of exogenous factors, including the SEC, AIG, the credit rating agencies, Congress, business academia and the business media.

Findings – The study argues that the lack of criminal prosecutions of key financial executives has been a key factor in creating moral hazard. Eight years after the Great Recession ended in the USA, the financial services industry continues to suffer from a crisis of trust with society.

Practical implications – An overwhelming majority of Americans, 89 per cent, believe that the federal government does a poor job of regulating the financial services industry (Puzzanghera, 2014). A study argues that the current corporate lobbying framework undermines societal expectations of political equality and consent (Alzola, 2013). The authors believe the Singapore model may be a useful starting point to restructure regulatory agencies so that they are more responsive to societal concerns and less responsive to special interests. Finally, the widespread perception is that the financial services sector, in particular, is ethically challenged (Ferguson, 2012); perhaps there would be some benefit from the implementation of ethical climate monitoring in firms that have been subject to deferred prosecution agreements for serious ethical violations (Arnaud, 2010).



Originality/value – The authors believe the paper makes a truly original contribution. They provide new insights via their analysis of the role of financial incentives, moral hazard and conflicts of interests leading up to the 2008 financial crisis.

Keywords Society, Financial crisis, Financial incentives, Financial services industry, Conflicts of interest, Moral hazard

Paper type Research paper

Introduction

It takes something more than intelligence to act intelligently (Fyodor Dostoyevsky, *Crime and Punishment*).

It is eight years since the Great Recession officially ended in the USA, in June 2009 (NBER, 2014). No other economic event, in recent memory, has provoked such profound self-examination in the USA of the ethical behavior of some of our most revered financial institutions. From a business and society perspective, the behavior of firms in the financial service sector has damaged confidence in society about the ethical integrity of the financial system (CBS/NYT, 2013). We are now in an excellent position, thanks to details emerging from hundreds of civil lawsuits, to reflect on the causes of economic collapse and to assess the lessons learned (Ferguson, 2012). Although the US economy has rebounded, the recovery has been slow and uneven (Lee, 2014). Median household income of US\$74,100 in 2012 lags that of 2006, when it stood at US\$93,800 (Bricker, 2012). Unemployment, at 6.3 per cent in 2014, has improved relative to the Great Recession height of 9.6 per cent, but lags pre-recession level of 4.6 per cent in 2007 (Labor UB, 2014). Young people are especially pessimistic about their future, with only 39 per cent believing they will be better off financially as compared to their parents. Comparable figures for Brazil and China stand at 84 and 81 per cent, respectively (Fry, 2013). Increasingly, young Americans are being asked to shoulder the financial burden of their college debt, with total student loan balances growing from US\$260bn in 2004 to US\$1.11tn, ten years later (Lee, 2013). The societal impacts of the Great Recession, thus continue eight years later.

The ethics literature has produced a considerable body of research which addresses the role of particular classes of “players” in the Great Recession. These include commercial banks (Soltani, 2014), financial professionals (Graafland and van de Ven, 2011), graduate business school education (Huhn, 2013), stockbrokers (Angel and McCabe, 2013), credit rating agencies (Scalet and Kelly, 2012), chief executive officers (Ferrell and Ferrell, 2010) and the business media (Chakravartty and Schiller, 2010). Very little research however, has focused on the relationships among key players and the co-occurrence of common structural flaws among various components of the global financial system. The focus on individual components of the financial system privileges micro-level analyses and ignores the complex relationships among government, markets and society that lead to system-wide failure. We address the call for more descriptive research to examine the interconnected roles of firms in society (Rowley and Berman, 2000).

This paper addresses the need to examine systemic defects in the system by focusing on the financial system as a whole, and the multifaceted relationships among key players in the system. Our study also addresses the need for consolidation in ethics research by applying common conceptual frames across industry, government, media and academic sectors (Wood, 2000). Much of the post-mortem analysis of the crisis in the popular press (Reckard and Hamilton, 2014) and even in academic journals (Boddy, 2011) offers up moral assessments of various parties to the crisis. Our focus, eschews such analysis, to concentrate

on more managerially relevant factors, such as the role of incentives/punishments, moral hazard and conflicts of interest among the key players in the securitization food chain.

We address the inter-relationships among components of the “securitization food chain”, i.e. homeowners, mortgage originators, investment banks and investors. We also address the role of exogenous parties, what we refer to as “key enablers”, i.e. the ratings agencies, AIG, Congress, regulatory agencies, academia and business media (Figure 1). We approach the financial crisis from a holistic perspective, analyzing the interrelationships among parties with the goal of developing a better understanding of systemic factors leading to the financial crisis. The research study may have several academic and practical contributions beyond the financial services sector to include any context involving problematic incentives and conflicts of interests. The analysis serves as a guide to regulators and to those in corporate governance in general, on how system wide failures and perverse incentives can lead to fraudulent behavior within organizations.

We organize the paper as follows: we begin by defining key terms in our analysis, such as conflicts of interests, incentives and moral hazard. Next, we describe the securitization food chain, including its key components, homeowners, mortgage originators, investment banks and investors. We also address the role of key exogenous “enablers” including the credit rating agencies, AIG, Congress, regulatory agencies, business academia and business media. Lastly, we offer up summary conclusions and recommendations.

Theoretical framework: the role of incentives, moral hazard and conflicts of interest in the financial crisis

In line with objectives in the introduction, we focus on managerially relevant variables that played a key role in the development of the financial crisis. These variables include direct and indirect incentives, conflicts of interest and moral hazard. We discuss these concepts in the context of relationships outlined in Figure 1.

Conflicts of interest

Conflicts of interest have been identified as key variable leading to unethical behavior in some industries, including medicine (Sah, 2013). We adopt McDonald’s definition of a conflict of interest. That is:

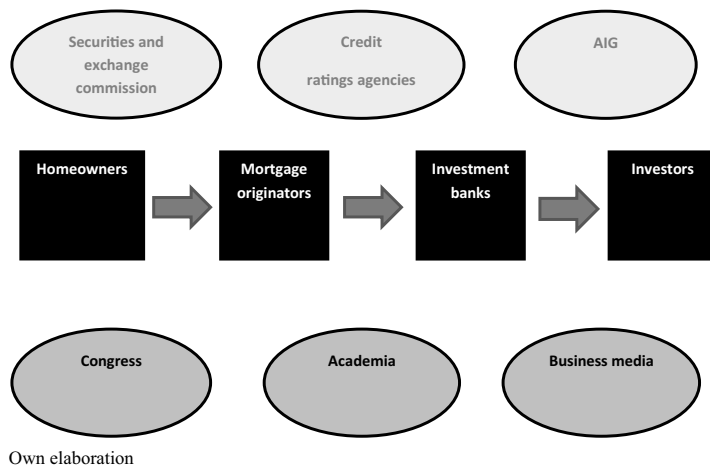


Figure 1.
Securitization food chain and key exogenous entities

a situation in which a person has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties as, say, a public official, an employee, or a professional (McDonald *et al.*, 2002, p. 68).

Charles Ferguson, in his Academy Award-winning documentary on the financial crisis, the *Inside Job*, cites several instances where conflicts of interest played a key role in the lead-up to the collapse of the financial system (The Inside Job, 2010). We will present evidence of conflicts of interest throughout the securitization food chain, depicted in Figure 1.

Incentives/punishments

The Board of Governors of the Federal Reserve System has identified risk-taking incentives, provided by incentive compensation arrangements in the financial services industry, as a key contributing factor to the financial crisis (Board of Governors of the Federal Reserve System, 2011). The widespread acceptance of the Anglo-Saxon shareholder model within the financial services industry, with its emphasis on the principal-agent problem of alligning incentive compensation with share price performance, was the moral and philosophical basis for such compensation practices (Quinn and Jones, 1995). The President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010. Among the Act's many provisions are new rules for incentive compensation. A large body of research in behavioral economics supports the view that proper alignment of incentives with a decision-making environment can be a powerful way to induce certain behaviors (Kamenica, 2012). We address the role of incentives/punishments, not only in the financial services industry, but also for all players in the securitization food chain. We identify "revolving door" as a type of indirect incentive to "look the other way" when employees, in relatively low paying regulatory jobs, are biding their time before they transition to more remunerative positions in the private sector. We see these indirect incentives as a key component of the broader process of regulatory capture.

Moral hazard

Moral hazard refers to a situation in which an individual or an institution is more likely to take risks because the costs that could result will not be borne by the party taking the risks (Dembe and Boden, 2000). Frequently, moral hazard occurs when there is information asymmetry, a situation in which a party in a transaction has more information than another, and one party is insulated from the negative consequences of the risk (Krugman, 2009). In the context of the financial crisis, a moral hazard exists if a financial institution knows it is protected by a lender of last resort (government) and, as a result, engages in riskier investments because it believes losses will be borne by someone else (Stiglitz, 2010). One peculiar aspect of moral hazard during the financial crisis of 2008 was the absence of criminal prosecution of organizations or individuals for criminal behavior. Instead, the "punishment" was borne by way of financial penalties, payed out by organizations, at the cost of their shareholders (Ferguson, 2012).

The securitization food chain

The securitization food chain is an industrywide supply chain for generating mortgages from homeowners and selling them to investment banks. Investment banks, in turn, repackage them into "structured" investments for sale to a variety of investors, including pension funds, hedge funds and other institutional investors. This supply chain integrates nearly every segment of the financial system (Ferguson, 2012, p. 40). The invention of new financial products such as credit default swaps (CDS), collateralized debt obligations (CDO)

and “synthetic” mortgage securities, all contributed to a complex, opaque system, wherein few understood the true dimension of the systemic risk for society. At the heart of the securitization food chain are four players: home owners, mortgage originators, investment banks and investors. The securitization food chain could not have prospered, however, with the tacit support of key exogenous players including the insurance giant AIG, the credit ratings agencies (CRA), Congress, various regulatory agencies including the Securities Exchange Commission (SEC), the Federal Reserve and the Commodity Futures Trading Commission (CFTC). Two additional “enablers” of the supply chain have received relatively little academic attention for their role in feeding the financial food chain – academic economists, business schools and business media, including business magazines and 24-h cable business channels (Chakravartty and Schiller, 2010). We now address the role of financial incentives, moral hazard and conflicts of interest among each of the majors players depicted in Figure 1.

Homeowners

Those on the ideological right argue that we should not neglect the role of individual responsibility and risky choices made by homeowner mortgage-holders as a contributory factor to the financial crisis (Milan and Sufi, 2014). A competing narrative, on the left, argues that predatory financial institutions preyed on unsophisticated borrowers with complex, variable rate, subprime mortgages (Ferguson, 2012). Noticeably, very little research has addressed consumer decision-making for home mortgages. What were the incentives for homeowners to engage in “risky” behaviour? And why did home mortgage purchasers engage in (on reflection) such poor decision-making? What was the role of marketing in consumer decision-making?

In the run up to the crisis, advertising campaigns, such as Citigroup’s “Live Richly” campaign, targeted middle-class America, urging:

[...] potential consumers not to work too hard, to not consider money be all that important, to find meaning and fun from activities that emanate from their own creativity, individuality and relationships with loved ones [...] (Marcus, 2005).

Campaigns such as the Citigroup campaign played their role in urging homeowners to borrow against the increasing equity in their homes. The campaign is illustrative of how marketing is implicated in the new spirit of excess of consumerism, where disenchantment with global consumer culture is repackaged in the promise of privatized life choices (Chakravartty and Schiller, 2010).

Like investment banks, consumers benefited from risky leverage of appreciating assets in an up market. The Case-Shiller US National Home Price Index doubled between 2000 and 2006, the largest and fastest increase ever recorded (Case-Shiller, 2012). Indeed, median household net worth soared in just two years from US\$84,400 in 2004 to US\$93,800 in 2006, largely driven by increased home equity (Lee, 2014). Then, there was the absence of punishment. Like the mortgage originators, homeowners who criminally falsified financial information for loan application documents, faced little risk of prosecution. So widespread was the problem that, as early as 2004, the FBI issued, and heavily promoted, a warning of “an epidemic of mortgage fraud” (Ferguson, 2012, p. 58). Eventually, all pretense of doing due diligence on the borrowers’ credit worthiness was abandoned with the emergence of “NINJA loans”, in which the borrower had no income, no job (and no) assets (NINJA). It is questionable whether many homeowners understood the details of some of the subprime mortgages they purchased. Robert Gnaizda, President of the Greenlining Institute in Berkeley, met with Fed Chairman, Alan Greenspan, once a year, and reported the following

conversation: “We gave him an example of Countrywide, and 150 different complex adjustable-rate mortgages. He said, “If you had a doctorate in math, you wouldn’t be able to understand them enough to know which was good for you and which wasn’t” (Greenspan, 2010).

From 2000 onward, as home values rocketed and wages stagnated, homeowners used their home equity as collateral to borrow more. This debt-financed consumption had real, if short term, economic benefits, fueling consumption-driven economic growth. Research indicates that much of the borrowing against home equity appears to have been spent on consumer goods and ill-fated improvements to homes whose values would soon plummet. Little of the borrowed money appears to have been used to pay off credit cards or invest in securities, or businesses (Akst, 2014). Some mortgage holders were home flippers – speculating on buying multiple houses with no intent to occupy them, hoping, however, to flip them at a profit. The *homo economicus* perspective sees these consumers as materialistic, utility maximisers, hoping to extract maximum individual profit. In this Darwinian view of the world, homeowners who leveraged the most won. In sum, according to the *homo economicus* view, homeowners made an economic bet and lost.

How useful is this perspective? The account of irresponsible, profligate borrowers, feeds into centuries-old narratives, condemning borrowers on moral and religious grounds. Whatever its truth value, it has little analytical usefulness if one’s goal is to redesign an economic system to prevent such a recurrence. One cannot legislate morality. One can, however, address the role of incentives that fuel such behaviour.

Unlike the Great Depression of 1929, when home debt relief was a major, if belated, response to the crisis, there appears to be little evidence that mortgage holders expected to be bailed out en masse by the federal government. Indeed, the tendency in the media to demonize overextended homeowners probably contributed to the muted response by the federal government to bail out homeowner debtors in the same way that the financial services industry was bailed out (Milan and Sufi, 2014). The behavior of home owners, therefore, does not seem to fit the definition of moral hazard; they could not reasonably believe that any other party would shoulder the expense of bailing them out. The financial incentives to take out mortgages were strong; a decade of Chinese purchases of US securities and a low interest policy of the “Greenspan” Federal Reserve made mortgages cheap. Tax incentives on mortgage interest expense, and an absence of punishment for lying about income on loan applications – a federal offense – all conspired to incentivise the “gold rush” to acquire ever larger mortgages. These financial incentives were clothed in a national ideology promoting a home ownership culture. The ideology was perhaps best championed by President George Bush, who famously stated on October 15, 2002, “you don’t have to have a lousy home, the low income earner can have just as nice a home as anyone else” (The Inside Job, 2010). On the left, the Community Reinvestment Act of 1977, contributed to the creation of a subprime market, and was seen as a way to encourage home ownership among minorities and low income groups.

To fully understand the behavior of homeowners, one must look to the role another key player in the securitization food chain; the mortgage originating sector for high pressure, deceptive and often illegal, sales practices.

Mortgage originators

The mortgage origination business underwent a dramatic restructuring in the 1980s. For decades, banks made home loans according to the “originate and hold” model. The bank that originated the mortgage held the mortgage. Thus, banks had a powerful financial incentive to do due diligence on the borrower’s ability to pay back the loan over the duration of the

mortgage. The new model “originate and distribute”, quickly dubbed “securitization”, pooled illiquid assets, like mortgages and transformed them into liquid assets that were tradable on the open market. These financial innovations were called mortgage backed securities (MBS). The new financial incentives for the mortgage originator were very different from the old “originate and hold” model. The primary economic incentive under the new “originate and distribute” model is to hold the mortgage for as little time as possible, before unloading it to the next player in the securitization food chain.

Each sale gives the mortgage originator more money with which to make more loans; it has little incentive to monitor the underlying risk of the mortgages it originates. In principle, the originate and distribute model works well so long as investors can accurately assess the risk inherent in the securities (Roubini and Minh, 2010). A transparent process facilitates risk assessment; an opaque, complex and fraudulent process frustrates due diligence.

Among the goals for regulation of any market are, first, to maintain market confidence, second, to secure an appropriate degree of protections for consumers and investors and, third, to reduce the extent to which a regulated entity can be used for a purpose connected with the crime. Remarkably, the mortgage origination business was largely unregulated. With the benefit of eight years of hindsight since the economic recovery officially began, we now have a large body of new information to shine a light on the inner workings of the mortgage origination business, thanks largely to information revealed in civil lawsuits among the parties for recovery of fraudulently obtained money.

Extensive evidence of unethical and sometimes, outright fraudulent behavior, in the mortgage origination sector, is revealed in recent civil lawsuits. Perverse incentives appeared to play a crucial role in many of these cases, including the following (Ferguson, 2012):

- Payments by lenders to mortgage brokers based on “yield spread premiums”. These incentives effectively functioned as inducements for pushing borrowers into the most expensive loans possible.
- Negative quality control. There was widespread evidence of covert strategies by senior executives at mortgage originators to emasculate in-house risk management and quality control functions. The muting of risk management appears to have been motivated by incentives that rewarded high-yield loans regardless of risks, and to cover up risks that were identified.
- The proliferation of deceptive loan structures and sales practices. More than 30 per cent of all homeowners receiving subprime loans during the lead-up to the financial crisis actually would have qualified for a prime loan.
- Widespread fraudulent deception committed against immigrants with poor English and weak financial skills who were misinformed about the contents of their loan documents. The incentives to prey on immigrants were strong as this group was unlikely to report malfeasance to the police. The FBI reported that “80 per cent of all reported fraud cases involve collaboration or collusion by industry insiders” (US Department of Justice Federal Bureau of Investigation, 2005, p. D1).
- CEOs of mortgage origination companies were aware of and incentivised the origination of loans they knew were likely to fail. At one company, the CEO made a presentation to their Board stating that their goal “was to achieve 82 per cent higher risk originations by 2008”, while internal reviews of one of their high-production centers revealed that 58 per cent of loans reviewed were found to have high levels of fraud. The managers of the unit involved were not disciplined, and investors were

not notified that the loans they had purchased from these centers contained fraudulent documentation.

- CEOs and senior executives presented false statements to investors, auditors and the public, both during the bubble and afterward, as their firms started to collapse.

While the above examples point to a case of systemic unethical practices and widespread fraudulent behavior in the mortgage origination sector, evidence also suggests that they were often abetted by auditing firms who “looked the other way”. The auditing firms showed “professional negligence” and investment banks continued to demand higher yielding loans from higher-risk originations. Investment banks were little concerned with the long-term performance of the collateralized debt obligations (CDOs) or evidenced much fiduciary concern for the welfare of their investor customers (Ferguson, 2012).

In the case of mortgage originators, there appears to be strong evidence that problematic incentives drove behavior that was frequently unethical, and often fraudulent. The lack of regulatory oversight, and the absence of civil or criminal litigation, all functioned to create a moral hazard at both an organizational and individual level. As there was no meaningful professional certification among mortgage originators, there was little opportunity for professional ethical indoctrination as is the case in other professional fields. At the organizational level, the risks associated with non-performing loans was not borne by the loan origination companies themselves under the “originate and distribute” model, but, instead, got passed along the securitization food chain – a classic case of moral hazard. At the individual level, those employees who offloaded risky, but profitable, subprime loans to “dupes” suffered no meaningful consequences when the home loans failed. Individual mortgage originators face little prospect of criminal prosecution or internal organization censure for criminal doctoring of loan documents.

More broadly, the above analysis of the mortgage origination industry points to the contested nature of corporate social responsibility (CSR) and the incompatibility of moral and governance frameworks within an industry not known for professional ethics training of its employees (Mitnick, 2000).

Investment banks

Critical reviews of the CSR literature have called for more descriptive research on how firms’ roles in society are shaped in the interactions between firms and their stakeholders (Griffin, 2000). We address these roles by examining a number of questions. Why did investment banks so aggressively incentivise unethical, and sometimes, fraudulent behavior for their partners, the mortgage origination companies? Why would they seek loans that would have a high probability of failing? Was this a simple case of information asymmetry, whereby only the mortgage origination companies truly knew the poor quality of their home loans? Answers to these questions are necessary before we can understand the role of CSR in the financial services sector.

The role of incentives at investment banks was more complex than the case at the mortgage origination companies. First, there was at least an implicit assumption that investment banks had a fiduciary duty to act in the best interest of their customers and counter parties. Second, some investment banks were so big, and so integrated into the global financial system, that their failure posed the threat of systemic global financial collapse. In other words, they were “too big to fail”.

Subprime home loans had higher interest yields and, therefore, could be packaged and sold more easily to institutional investors, so long as they continued to receive AAA, the highest quality investment grade from the CRA. Investment banks rarely held onto these

CDOs for longer than one or two months, before offloading them onto investors; consequently, their risk was limited to this brief holding period. Investment banks had an incentive to source subprime loans over prime, and to pass the economic incentives down the securitization food chain. Evidence from civil lawsuits shows that internal investigations at investment banks revealed the extent of the problem with the quality of loans sourced, and that many loans clearly violated their own internal risk standards. When given a choice to reject these mortgages, or ignore their internal standards, investment banks invariably chose the latter (Ferguson, 2012, p. 100).

Stockbrokers have a legal and ethical requirement to recommend only “suitable” investments to their customers, but contrary to popularly held beliefs before the crisis, most brokers do not have a stricter, legal fiduciary duty to their customers (Angel and McCabe, 2013). This was but one of the many examples of information asymmetry that existed between agents of investment banks and customers who bought CDOs. The information asymmetry created a moral hazard for the investment banks’ agents, as they were insulated from civil lawsuits based on alleged violations of fiduciary duty to investors. Brokerage firms often have numerous conflicts of interest with their customers in that products that pay the highest commissions may not be the best ones for their customers. Commissions create powerful incentives for the entire securitization food chain but at the same time produce conflicts of interest – a type of ethical pollution. It is doubtful that most customers are aware of the extent of these conflicts of interests, thus creating a classic asymmetry of information. Given that the CDO market is more complex and less transparent than the equity market, the information asymmetry works against efficient markets.

A second issue of incentives concerns the role of executive compensation. Many believe that excessive executive compensation and flawed incentive compensation practices can at least be partly blamed for the imprudent risk-taking that helped spark the economic crisis (Grant Thornton, 2014). The bonus culture mentality of the investment banks was born out of an attempt to address the age-old principal-agent problem. To align compensation of agents (executives) more directly with the interests of principals (shareholders), bonuses were used to reward executives for actions that maximised profitability. This is standard practice in corporate America. The incentive problem at investment banks, however, was the mis-aligned timing of incentives versus performance; cash bonuses were awarded based on short-term profits, but there were no penalties for long-term losses. Consider the basic bet: you make an extra US\$10m a year by making high-risk, high-reward bets, but you put your financial institution at risk. If the institution fails, shareholders pay the bill. If your institution is too big to fail, tax payers pay the bill. The bet is fraught with moral hazard. The problem with bonus-heavy incentives was particularly acute at investment banks. This was because many employees below the level of top executive positions were engaged in activities sufficiently risky to expose their institution to material financial loss, e.g. traders with large position limits relative to the bank’s overall risk tolerance (Board of Governors of the Federal Reserve System, 2011). Similarly, groups of employees who are subject to similar incentive-based compensation arrangements may, in the aggregate, expose a financial institution to a material amount of credit risk (note this was wisepread in the loan origination business).

The systemic risk posed by these incentive structures was described in 2005, by Raghuram Rajan, then the chief economist of the International Monetary Fund. He delivered a paper at the annual Jackson Hole Symposium, the most elite banking conference in the world. Rajan’s paper focused on incentive structures that generated huge cash bonuses based on short-term profits, but which imposed no penalties for later losses. Rajan argued

that these incentives encouraged bankers to take risks that might eventually destroy their firms, or even the entire financial system (2006). Raghuram later added:

It's very easy to generate performance by taking on more risk. And so what you need to do is compensate for risk-adjusted performance. And that is where all the bodies are buried (2010).

There have been some proposals to address the incentive problem at investment banks. Among them include the need to (Board of Governors of the Federal Reserve System, 2011):

- make risk adjustments to the amount of incentive compensation award for an employee to take into account the risk the employees' activities may pose to the organization;
- defer a portion of the incentive compensation awards;
- identify key employees for whom incentive compensation arrangements may pose a threat to the organization's safety; and
- involve risk-management and control personnel when designing incentive compensation arrangements.

Perhaps a more radical approach to executive compensation is warranted in light of increasing evidence that the favored tools of regulators and shareholders – deferral and often complex long-term incentive structures – may not produce the hoped-for results (PWC, 2012). A PWC survey of global senior executives in the financial services sectors shows that only a limited number of executives are motivated by highly leveraged and volatile pay packages. The same survey found that participants believed that pay is as much about fairness and recognition as it is about incentives. The exclusive focus on share price incentive models of executive compensation may potentially blind us to viable alternatives to organizing the relationship between the investment banking industry and society (Matten and Moon, 2008).

In sum, when one evaluates behavior in the investment bank sector, problematic incentives, moral hazard and conflicts of interests (exacerbated by information asymmetries) appear to play a large role in executive decision-making. The actions undertaken by investment banks in constructing risky CDOs, on a base of shaky subprime mortgages, however, would not have worked were it not for the cloak of legitimacy provided by the CRAs. Without the AAA seal of approval from the CRAs, the banks could not have sold these CDOs to institutional investors. Next, we examine the role of incentives, conflicts of interest and moral hazard at the exogenous entities, beginning with, CRAs.

Exogenous entities

Credit rating agencies

The CRA industry operates as a specialized information market whose product serves as a public good. CRAs evaluate securities issued by firms and governments to determine the likelihood that the issuer will repay the debt. CRAs use their proprietary models to provide a single rating, such as AAA or Aaa, to represent the creditworthiness of firms. Many investors relied on these ratings, and for institutional investors, the expert opinion functioned as authorized seals of approval (Steven and Kelley, 2012). Additionally, CRAs advise issuers of CDOs how to package their debt instruments to receive a favorable rating. Investment banks, in turn, rely on these ratings to attract investment buyers (Rom, 2009). Few would argue that the CRA performed their function adequately in the lead-up to the financial crisis. In the span of a couple of months, in 2008, previously AAA-rated bonds fell

into junk status to the tune of US\$14tn. Days before AIG was bailed out by the government, it had received AA ratings from the CRA.

The CRA industry is regulated by the Securities and Exchange Commission (SEC) whose responsibility, for the CRAs, is to ensure the quality of ratings and prevent conflicts of interests. By its criteria, the SEC failed in its supervisory role over the CRAs. The CRAs illustrate the presence of conflicts of interest, problematic incentives and moral hazard.

The issuer-pay compensation model creates a prima facie case of conflict of interest. The problem is confounded when CRAs offer consulting services to bond issuers on how to design CDOs to get specific ratings. The conflict of interest arises if the CRA privileges the satisfying of client interest over the provision of accurate ratings. The consulting conflict of interest arises when the CRA receives significant fees for consulting services on how to package securities that they will later rate. The conflicts of interests between lucrative revenues versus accurate rating creates an environment where “tying” and “notching” are likely to occur. Both of these activities are explicitly proscribed by the SEC, but there appears to have been little attempt at enforcement (Coskun, 2008). Before the unravelling of the crisis, many investors believed that the CRAs had a legal obligation to provide accurate ratings. As the crisis unfurled, many were dismayed to find that the CRAs “analysis” was insulated from lawsuits via first Amendment, free speech protection; the “analysis” represented nothing more substantial than their “opinions”. The “free speech” protection for the CRA effectively functioned as a moral hazard, ensuring that the CRAs would bear no legal – and in turn, no financial – consequences for their inflated ratings. The impact of the moral hazard was all the greater for the extent of the information asymmetry that existed between corporate lawyers of CRA and the outside investors. The conflicts of interest built in to the issuer-pay model ensured that the financial incentives for the CRAs rewarded behavior that tailored pleasing ratings to their customers at the expense of accurate information for the investor. Another aspect of conflict of interest is the concept of the “revolving door”. The movement of individuals from the CRA to investment banks, often at multiples of salaries, sometimes to institutions whose CDOs they had previously rated, creates an additional conflict of interest and indirect incentive to “look the other way” when tasked with rating future employers’ securities. Staff at CRA know that their future career prospects are often at stake when they evaluate securities from customers. Because CRA produce a public good, the combination of conflicts of interest and distorted incentives served to create a “captured agency”. A captured agency occurs when a regulatory agency, created to act in the public interest, instead advances the commercial concerns of a particular group (Lee, 2006). As such, it represents a case of government failure because it creates an opening for firms to behave in ways injurious to society (e.g. producing negative externalities). Strier recommends that the federal government prohibit the issuer-pay model, ban CRA from rating issues from the same client for more than five years, and from consulting on the design of any issue it rates (Strier, 2008). The SEC, with input from the CRA industry, is currently evaluating the best response to regulating the the CRAs.

Securities and exchange commission

The SEC, along with the Federal Reserve (Fed) and the Commodity Futures Trading Commission (CFTC), is one of a number of regulatory institutions whose statutory role includes the assurance of the efficient functioning of the financial services market and the protection of investors. The SEC, in particular, has come in for substantial criticism for its

failure to live up to its statutory mandate in the lead up to, and the subsequent unfolding of the financial crisis. Among the criticisms levelled at the SEC, include conflicts of interest, revolving door policy, insufficient financial incentives to hire and maintain highly qualified staff; all attributes that point toward regulatory capture. Harry Markopolos, a financial analyst who spent more than a decade giving repeated warnings of fraud to the SEC regarding Bernie Madoff, has called the agency “nonfunctional captive to the industry” (Pressman, 2009). Significant conflicts of interest arise over the SEC’s revolving door between staffers and the firms they regulate. The list of officials who have left the SEC for lucrative jobs in the private sector and who have sometimes returned to positions in the SEC, is long. This latter trend, referred to as “opposite revolving door”, is particularly troublesome because it heightens the concern that the conflict of interest could bias SEC oversight and undermine public confidence. A second manifestation of the revolving door has been the political appointments of former industry executives into positions of significant influence over regulations that relate to their former firms (POGO, 2011). Some of these concerns could be addressed by strengthening post-employment restrictions.

One way to ensure a regulatory agency does not, or is incapable, of fulfilling its mandate, is to starve it of sufficient resources to do its job. The SEC has been described as underpaid and understaffed (Ferguson, 2012). The provision of sufficient resources to the SEC to enable it to fulfill its statutory mandate is the responsibility of Congress. One model that could address some of concerns noted above is the so-called Singapore model, whereby senior regulatory officers are paid market wage rates comparable to remuneration in the financial services industry. Lee Hsien Loong, Prime Minister of Singapore, has argued that incentives are needed to ensure that public service is not so great a sacrifice that capable people do not care to serve in it (Loong, 2012). Nouriel Roubini, economics professor at NYU, put it more directly, “people charged with overseeing the stability of the global financial system should reasonably be paid more than a receptionists at Goldman Sachs” (Roubini and Minh, 2010, p. 220). Singapore was not subject to excessive financial leverage of its institutions, being more tightly regulated, and thus largely survived the financial portion of the crisis unscathed (it did not escape other collateral effects of the crisis such as the drop in world demand for its exports).

The harshest criticism admonishes the SEC for its failure to prosecute allegations of widespread criminal behavior in the financial services industry (Ferguson, 2012). The lack of meaningful individual penalties for criminal wrongdoing has led to a cascading series of allegations that financial services firms are “too big to fail” or “too big to prosecute” or “too big to jail” or “too big to bar” (Lynch, 2014). During the Savings and Loan (S&L) crisis of the 1980s, a crisis that “only” cost the taxpayer US\$124bn, thousands of S&L executives were prosecuted and hundreds went to jail. As of mid-2014, no senior executive, directly involved with the crisis, has been criminally prosecuted. The statute of limitations runs out for many by the end of 2014. The allegations of criminal wrongdoing in the financial services industry include securities fraud, accounting fraud, honest services violations, bribery, perjury, making false statements to federal investigators and Sarbanes-Oxley violations (certifying false accounting statements) (Ferguson, 2012, pp. 190-207). Failure to prosecute criminal behavior leads to moral hazard. Often firms have been willing to pay large sums to lock up deferred prosecution agreements, at shareholder expense, to avoid “uncertainty” and personal embarrassment (Bloomberg Businessweek, 2014). In Stiglitz’s view, investment banks view fines as a cost that is outweighed by the potential profit generated by the actions being sanctioned (Stiglitz, 2010). Absent individual prosecutions for criminal behavior, agents face a moral hazard, with the cost borne by

principals (shareholders) and society. Unless there is specter of jail time and a personal reputation hit, there is little reason to fear retribution from the law. Prosecutors with limited resources, no matter how dedicated to duty, find it difficult to avoid being seduced by negotiated settlements and the fiction of victory. Unless prosecutors face sanctions for failure to get individual criminal convictions where criminal fraud has occurred, they too, face a moral hazard.

AIG

Perhaps no single private institution played a more critical role in the financial collapse than AIG. AIG is a multinational insurance company, which specialized in selling insurance on events – such as the bankruptcy of an investment bank – that were unlikely to occur in any given year. In the short run, betting huge amounts of money insuring against catastrophes yielded large revenues and bonuses at AIG. AIGFP, a London subsidiary of AIG, insured over \$500 billion dollars of CDOs against default with CDS. Because credit default swaps were unregulated, AIG did not have to put aside any money to cover potential losses, and chose not to purchase reinsurance to hedge against that risk. For investors who owned CDOs, credit default swaps worked like an insurance policy. An investor who purchased a credit default swap paid AIG a quarterly premium. If the CDO went bad, AIG promised to pay the investor for their losses. Unlike regular insurance, speculators could also buy credit default swaps from AIG to bet against CDOs they did not own. AIG used collateral on deposit to buy MBS. When the value of these MBS began to plummet as the crisis in the mortgage market unraveled, AIG had to pay out insurance claims and had to replace losses in its collateral accounts (Greenberg and Cunningham, 2013). The resulting liquidity crisis, and imminent bankruptcy, forced the Fed to step in to provide US\$85bn in liquidity so that AIG could honor its credit default swap trading partners. In the end, the inevitable happened, and when AIG failed, the consequences for these excessive risks were borne by someone else – the US taxpayer.

The AIG case represents a clear case of moral hazard and the challenge represented by what economists call the principal-agent problem (Roubini and Minh, 2010). For large-scale institutions such as AIG, the principals (shareholders and board of directors) must employ agents (managers) to serve their best interests. Agents invariably know more about what is happening at the company (asymmetric information) than principals who may pursue their own self-interest to destructive effect. The challenge is how to structure incentives so that agents do not use the firm's resources to place outsize, risky bets, to maximize their bonus and risk destruction of the firm. In the case of AIG, it was the actions of a relatively small number of individuals, based in London, which brought the ruin of a company, and a global financial system to the brink of collapse. The principals at AIG were not ignorant of the risk posed by the London office of AIGFP. In 2007, AIG's auditors raised warnings. One of them, Joseph St. Denis, resigned in protest after Joseph Cassano, head of AIGFP, repeatedly blocked him from investigating AIGFP's accounting. As was the case in the mortgage origination sector, AIG and investment banks frequently looked the other way when risk management or internal auditors questioned risk exposure.

One might expect that shareholders would be highly motivated to prevent such destructive behavior since they are ultimately the owners. However, as Roubini and others have pointed out, shareholders of financial firms often do not have so much skin in the game, as these firms rely so heavily on borrowed money to finance their operations than do firms in the non-financial sector. Absent engaged shareholders, one is left with unsecured creditors of banks and other financial institutions to impose market discipline. However, the

belief in the lender of last resort support from the Fed undermined the motivation to act. In one of the more glaring conflicts of interests during the crisis, Treasury Secretary and former Goldman Sachs CEO, Henry Paulson, played a key role in ensuring that over US \$60bn of taxpayer bailout money went to pay holders of CDSs in full, with US\$14bn going to Goldman Sachs.

Investors

Investors were global – foreign investors bought more than half of CDOs and mortgage-backed securities (MBS) – among their ranks included pension funds, hedge funds, foreign banks and other institutional investors. Yet, relatively little is written about the role of those who bought the CDOs and the MBS that fueled the crisis. Nonetheless, incentive compensation among employees who worked at hedge funds was also geared toward leveraging risk. For hedge funds, compensation at the firm level was the so-called 2 and 20: customers were charged fees of 2 per cent of assets managed, while the fund kept 20 per cent of all gains. However, the fund did not participate in losses, creating an appetite for risk and moral hazard. A similar type of compensation structure operated at pension funds and mutual funds, in that incentives were structured to achieve optimal yield, with little attention paid to long-term performance. In time, pension funds and mutual funds came to trust the ratings of the CRAs uncritically, instead of doing their own independent research. Unlike some of the unsophisticated homeowners who took out ill-suited subprime loans, most of the investors were sophisticated institutional buyers and sometimes, even hedge fund arms of investment banks. They had access to market analysts and an unending stream of proprietary research. Therefore, a plausible argument can be made that *caveat emptor* should apply. The same access to proprietary research was not available to the public. What investors did not know, and could not know – as CDS were unregulated – was that, as early as 2006, Goldman Sachs (and later, other investment banks) started actively betting against CDOs it had sold to customers. By purchasing credit default swaps from AIG, Goldman could bet against CDOs it did not own, and then be paid when the CDOs failed (Ferguson, 2012, pp. 127-132). Neither academic economists nor the 24-h business media seemed any better informed about these ominous developments.

Academia

Some economists, such as Jon Hanson, argue that the phenomenon of regulatory capture extends beyond just regulatory agencies. Business has an incentive to control anything that can exert control over them, including the business media and academia. This phenomenon is called “deep capture” (Hanson and Yosifon, 2003). Academia has long been viewed as a relatively independent source of critical analysis of the financial system. In *Inside Job*, Charles Ferguson paints an alternative picture of academics as cheerleaders and apologists for the financial services sector. Among Ferguson’s assertions is that the financial services sector creates conflicts of interest in academia. This is achieved through the funding of think tanks at academic institutions, opinion pieces at leading newspapers and appearances on 24-h business cable channels; speaker bureaus used to disguise payments to academic economists for lobbying and policy advocacy; and lucrative board membership on investment banks (Ferguson, 2012, pp. 240-274). In particular, Ferguson asserts that two-thirds of leading economists in the fields of industrial organization and antitrust analysis have been adversely affected by academic conflicts of interests. Furthermore, he asserts, because the scope of these conflicts of interest entails so many economists, the SEC is often stymied in its attempts

to hire expert witnesses from academia. Driven partly by the criticism of academic economists' muted response to the financial crisis, in 2012, the American Economic Association belatedly adopted a code of ethics requiring the disclosure of conflicts of interest in its seven top academic journals.

Since the 1980s, academic economists have been major advocates of deregulation, and played influential roles in shaping the US Government policy. In the lead up to the financial crisis, the academic economists framed the discussion of how free markets should operate, championed the economic contributions of the financial services sector and offered an intellectual bulwark against new financial regulations. Very few of these economic experts warned about the crisis, and even after the crisis, many opposed regulatory reform. It is unquestionably true that modern financial innovations are critical to the smooth working of a global economy. Yet, by early 2000, financial services firms were accounting for over 40 per cent of all corporate profits – far out of proportion to their contribution to national Gross Domestic Product (GDP). Former Chairman of the UK Financial Services Authority, Lord Turner, asked if modern finance had become a rent-extracting industry, that is, earnings derived largely from leveraging one's position as a bottleneck, rather than from real economic contributions (Marr, 2009). In business schools across the country, from the mid-1990s onward, neo Keynesianism, and its more accommodating stance toward regulation of markets, was on the defensive. In its place, was the widespread celebration of the victory of unregulated markets, the championing of new financial innovations, such as the securitization of subprime mortgages and growth of over the counter derivatives. The naturalization of the market, and the privileging of shareholder interests over stakeholder interests, became increasingly dominant in elite business schools (Huhn, 2013). McMurtry has described this cultural transformation as the growth of the life-blind structure of economic rationality (McMurtry, 2012).

Business media

The complicity of the business media in creating the financial crisis was perhaps best captured by the comedian Jon Stewart, whose interview with Jim Cramer from CNBC's *Mad Money*, became an online sensation after its airing in 2009 (Stewart, 2009). In essence, the interview revealed the enormous gap between what cable news advertises itself to its viewership – a vigorous watchdog of all things financial – versus the reality of its cheerleading of the performance of investment banks both before and during the early stages of the crisis. A study has asserted that economic journalism has been no mere reflection, but a constitutive element of the crisis (Chakravartty and Schiller, 2010). Economic pressures for ratings and advertising revenue distort coverage in favor of infotainment over in-depth scrutiny of social actors and the political-economic processes that helped propel the crisis. The current economic model that drives news media substitutes features and editorial over the expensive process of investigative newsgathering. The conflicts of interest arise when the cheerleading activities of such shows such as *Mad Money* drive ratings, advertising revenue and “softball” interviews. Indeed, the show's daily stock recommendations seemed like a metaphor for a recurring theme of short-term performance incentives, with little accountability for long-term performance. The sensationalism of the daily stock recommendations grabs ratings and advertising revenue while the value of the securities recommended tended to fall after just two days (Karniouchina *et al.*, 2009). Like the investment banks, the business news media feel the same pressure to “dance until the music stops”. Miller has argued that the hyper-speculative news frame serves to depoliticize an underlying ideology of radical market fundamentalism

(2009). Lost in the clutter of the 24-h business news cycle was any meaningful discussion of urgent policy choices. The vacuum, instead, was filled with endless coverage aimed at the consumer of financial services, privileging minute-to-minute coverage of the gyrations of the stock market. If business media and academia do an inadequate job of policing the financial services sector, then the ultimate power and responsibility to do this rests with the US Congress.

Congress

The relationship between the financial services sector and Congress is analogous to its relationship to academia and the business media, i.e. it seeks to control that which would restrict the scope of its freedom to act. Vested interests in the financial services industry have a stake in regulatory activity as the scope of its operations is subject to a wide array of regulatory institutions. As we have seen in our discussion of academia, when regulators form expert commissions to examine policy, they seek input from academic and industry experts. The academic literature focuses on how smaller government units are easier for concentrated industries to capture. One study presents the opposite scenario, where large, powerful industries, such as financial services, can capture national government and use that power to block policies at the state level that voters may want (Moore and Giovinazzo, 2012). The most dramatic example of regulatory capture of a national government by the financial services sector was Iceland. At the time of its financial collapse, in late 2008, it had a population of 320,000, a GDP of US\$13bn and bank losses of US\$100bn (Ferguson, 2012, p. 253). In the decade leading up to the US financial crisis, the financial services industry spent US\$5bn in lobbying and campaign contributions, while employing more than 3,000 lobbyists – five for each member of Congress. The conflicts of interests in this scenario seem self-evident. Are politicians responsive to the electorate, or to a powerful financial oligarchy? Dominique Strauss-Kahn, former head of the International Monetary Fund, has speculated whether the strength of the global financial services industry is a threat to political democracy (2010). Industry has every legal right to lobby Congress for first amendment rights, so the issue is not one of rights, but rather of the economic effects of such rights on society.

The financial services sector has had legislative success in the decades leading up to the crisis, including its signature victory, the repeal of Glass-Steagall, the Depression era legislation that created a firewall between commercial banks (which took deposits and made loans) and investment banks (which underwrote, bought and sold securities). Congress repealed the last vestiges of Glass-Steagall with the Financial Services Modernization Act in 1999. The latter Act effectively declared most derivatives off limits to regulation, and setting the stage for the explosive growth of CDS that ultimately undermined AIG. The FSM Act was debated in neither the Senate nor the House. The symbiotic relationship between the government and the financial services sector thus produced a dramatic change in the governance system as it related to the finance industry. Investment banks reacted to this deregulation by massively increasing its leverage to as much as 33/1 (meaning that a 3 per cent decline in assets would effectively make it insolvent). The ideological champion of a radical deregulated approach to free markets was Fed Chairman, Alan Greenspan. Greenspan had little interest in the widely held central banking philosophy that powerful institutions should attempt to inoculate the economy against the growth of financial bubbles. This was evident in his response to the 1987 stock market crash, when he was willing to use all the powers of the Fed to rescue it. This philosophy created a Greenspan “put” – i.e. the market guessed correctly that the Fed would ride to the rescue after a bubble collapsed. It created a moral hazard on a grand scale.

Neither did the financial service industry have to worry too much about substantial penalties for what many believe to have been widespread criminal behavior in the industry (Ferguson, 2012). The Obama administration has excused its failure to prosecute for bubble-related crimes, by arguing that while much of the behavior in the financial services sector was unethical, it was not illegal “part of my frustration, was that a lot of practices that should not have been allowed weren’t necessarily against the law” (Obama, 2011). The lack of criminal prosecutions, in stark contrast to what happened in the aftermath of the S&L crisis in the 1980s, served to strengthen the effects of moral hazard. As of July 2014, two investment banks have pleaded guilty to criminal charges, Credit Suisse and BNP Paribas, the first to collusion to defraud the US Government of taxes, and the latter to money laundering for nations deemed security threats to the USA. Neither bank pleaded guilty to any charges directly related to its role in the financial crisis. The BNP plea is an example of the principal-agent problem in that burden of the US\$9bn in fines for the criminal actions of individuals – the agents of the firm – will be borne by the principals (shareholders). This lead FBI Director, James Comey to say, “Until shareholders hold corporate chiefs accountable for following the law, the money will keep walking out the door” (Reckard and Puzzaghera, 2014).

However, the agents who steer large financial firms appear willing to settle for non-prosecution agreements with large penalties, at shareholder expense, to avoid the embarrassment and the personal peril of extended trials. Prosecutors, with increasingly limited resources, due to Congressional “fiscal rectitude”, are often seduced by easily negotiated, non-prosecution settlements. Conversely, what is to protect companies from Department of Justice (DOJ) or SEC from shakedowns? (Bloomberg Businessweek, 2014). Congress can make it more difficult for prosecutors to take the easy way out by ordering them not to take action against companies unless individuals are being charged as well. Unless individuals are held accountable, for individual criminal behavior, moral hazard will continue to be a powerful force in the financial services industry.

Conclusion

Our analysis has identified common structural flaws throughout the securitization food chain. These structural flaws include inappropriate incentives, the absence of punishment, moral hazard and conflicts of interest. We see the full impact of these structural flaws when we look at their co-occurrence throughout the financial system. The structural flaws extend to government, regulatory agencies, business academics and the business media. Our study moves beyond moral analysis and normative ethical concerns, with the assumption that very few parties to the crisis are without moral culpability, and instead, we focus on systemic issues that are addressable via policy changes. We hope the study will serve as a guide to regulators, and to those in corporate governance in general, on how system-wide failures and perverse incentives can lead to fraudulent behavior in organizations and detrimental effects on society.

We believe that for free markets to work as intended, it is critical to maintain market confidence, that is, a widespread belief that the same rules of the game apply to all players, and that none are above the law. The lack of any criminal prosecutions related to this crisis has damaged such confidence. In a CBS News/New York Times poll in 2012, only 9 per cent of those polled expressed “A lot of confidence in banks and financial institutions”, while 49 per cent believed that “Corruption in banks and financial institutions is widespread” (CBS/ NYT, 2012). The financial crisis has shaken society’s confidence in the integrity of the financial system. In a national survey by Better Markets, nearly two-thirds of Americans think the stock market is rigged against them and a majority believes that Wall Street and

financial institutions hurt average Americans (Puzzanghera, 2014). One might expect that with such concerns about the financial sector, the public would be strongly in favor of new regulations to impose market discipline, but the public seems deeply divided on this issue. When asked if they thought federal government regulates business too much/too little/right amount these days, 49 per cent agreed with “too much” versus 22 per cent with “too little” and 19 per cent with “right amount” (CBS/NYT, 2012). It would seem that the public has little confidence in government, as they perceive members of Congress to be captive to special interest groups. A 2013 CBS/NYT poll asked people “Do you think most members of Congress are more interested in serving the people they represent, or more interested in serving special interest groups?” Eighty-five per cent responded “special interests” versus nine per cent “people” (CBS/NYT, 2013). The public’s cynicism with the financial services sector is surpassed only with its cynicism of Congress, and points to a collective pessimism that any meaningful reform is possible.

In times of crisis, we might look to media journalism and academia to clarify essential truths. What are the true causes of the crisis? What are its social costs? What new political and economic reforms do we need to have in place to ensure no future re-run of this crisis? How do we ensure that principles of democratic accountability apply to those culpable of subverting existing laws? We have identified business media and business academia as key enablers of the crisis, yet each is subject to similar structural flaws and compromises as other players in the securitization food chain. Therefore, before either can assume positions of intellectual leadership, they too will require reputational makeovers.

We identified risk-taking incentives, provided by incentive compensation arrangements in the financial services industry, as a key contributing factor to the financial crisis. It is now generally understood that compensation practices, which feature a short-term bonus culture with no clawbacks for long-term performance are problematic. What was less understood is how employees, several layers below top level executives, were engaged in speculative activities sufficiently risky to expose their institutions to peril. Given the questions that have been raised by PwC consulting group and others regarding the efficacy of complex, contingency-based bonus structures, perhaps it is time for behavioral economics to readdress the principal-agent problem as it relates to bonus structures. At mortgage origination companies, we see how groups of employees, in relatively modest positions, but subject to similar incentive-based compensation arrangements, can, in the aggregate, expose their institutions to failure. Such incentives, in the absence of any professional qualifications and ethics training, can lead to being ethically questionable, and often, fraudulent behavior. Incentive compensation played a lesser role in the decision-making behavior of investors. Nonetheless, pension funds and other institutional investors, incentivised with short-term volume goals, may have had their due diligence clouded to the long-term economic performance of the securities they purchased on behalf of their clients.

It is perhaps surprising, that in a digital age of proliferation of information, that information asymmetries played such a role in the many conflicts of interest among the parties implicated in the securitization food chain. For financially unsophisticated homeowners, the lack of any meaningful disclosure requirements on loan origination documents left them easy prey for unscrupulous mortgage originators. New disclosure requirements of the Dodd–Frank Wall Street and Consumer Protection Act aim to address this issue. It is now generally understood that investment banks have neither a morally accepted, nor legally imposed, fiduciary duty to their customers. Presumably, caveat emptor, will be the dominant creed among investors for the foreseeable future. However, one pernicious aspect of conflicts of interest remain – the revolving door between regulators, government and industry. Unless Congress allocates sufficient resources to regulatory

authorities such as the SEC, to hire and retain the highest quality personnel and then to hold them accountable via strict post-employment restrictions, society will continue to lack confidence in the ability of these institutions to fulfill their statutory mandate. Given the public's current deep suspicion of Congress, it seems unlikely that such reforms are politically feasible.

As lender of last resort, the government is in a unique position to create moral hazard for all the players in the securitization foodchain. The US\$700bn bailout of financial institutions was controversial on both sides of the ideological aisle: on the right, because it meant a *de facto* admission of market failure, and on the left, because the bailout privileged the needs of Wall Street over Main Street. The more subtle, but no less pernicious form of moral hazard, was the abject failure to hold responsible parties liable for criminal behavior. That thousands were prosecuted, and hundreds were jailed, for criminal behavior related to the 1980s savings and loan crisis, makes it implausible that similar behavior did not occur during the crisis that led up to the Great Recession. The criminal misdeeds of the financial sector have been extensively documented (Ferguson, 2012). The morphing of "too big to fail" into "too big to prosecute" may well be the most important legacy of the Great Recession. Absent individual prosecutions for criminal behavior, agents face a moral hazard, with the cost borne by principals (shareholders) and society.

We see a number of productive opportunities for research on the relationship between the financial services sector and society. First, we see the need for additional empirical and descriptive research into why stakeholder theory (Mitchell *et al.*, 1997) and CSR concepts seem to have gained so little traction in guiding the actions of executives in the investment banking and mortgage origination business. Even when the financial services sector does commit to a broader agenda of CSR, evidence indicates that such commitment is ambiguous and piecemeal (Furrer *et al.*, 2012). Is ethical training in our graduate and undergraduate business schools providing the necessary support for stakeholder theory? Empirical research provides support for the notion that well designed business school ethics courses cause students to be less supportive of "stockholder-only" view of business (Simmons *et al.*, 2009). Or is ethics education "captured" by those who teach the primacy of stockholder perspectives in finance? Second, research needs to address how CSR in the financial services sector is shaped in the interactions between incentive structures and the behavior of senior executives within the firm toward external stakeholders, such as customers and society (Frooman and Murrell, 2005; Mazutis, 2013). Third, research in the financial services sector needs to address the apparent incongruity between the formal descriptions of governance structures within financial services companies, as reported in internal written documents, such as corporate profile and statements of corporate values and identity, and actual policies and behaviors, as reported in the details of documents emerging from subsequent civil lawsuits (De Graaf and Stoelhorst, 2009). Fourth, we need a better understanding of how formal mechanisms of governance structures in the financial services sector, such as risk management, are undermined by informal structures, such as emergent organizational culture. Fifth, our study of the financial services industry points to the need for additional research into the relationship between business and society and the threat of regulatory capture and revolving door indirect incentives. In particular, additional research is necessary to integrate the role of financial services lobbying within the broader context of financial services CSR (Anastasiadis, 2013). An overwhelming majority of Americans, 89 per cent, believe that the federal government does a poor job of regulating the financial services industry (Puzzanghera, 2014). Another study argues that the current corporate lobbying framework undermines societal expectations of political equality and consent (Alzola, 2013). We

believe the Singapore model may be a useful starting point in restructuring regulatory agencies so that they are more responsive to societal concerns and less responsive to special interests. Finally, there is widespread perception that the financial services sector, in particular, is ethically challenged (Ferguson, 2012). Perhaps there would be some benefit from implementation of ethical climate monitoring in firms that have been subject to deferred prosecution agreements for serious ethical violations (Arnaud, 2010).

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