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The Global Credit Crisis Is Greed the Culprit?

Focusing exclusively on greed as the culprit in the global credit crisis might be an easy distraction drawing our attention away from more complex sources of instability which need to be addressed by people contemplating reform.

Under questioning from US House of Representatives Oversight and Government Reform Committee chairman Henry Waxman, Richard Fuld, the former chief executive of failed investment bank Lehman Brothers, denied he had received \$500 million in compensation. No way, according to an unrepentant Fuld; it was only \$250 million and only \$60 million was in cash.

Fuld and a few others have become the symbols of today's market failure and the unacceptable faces of capitalism in the cross hairs of those who want to radically recast our economic system.

For many, greed and an associated failure of ethical standards are at the heart of the crisis. The United States Conference of Catholic Bishops in a letter to Congressional leaders identified "clear ethical dimensions which should be at the center of debate and decisions on how to move forward". They described the "scandalous search for excessive economic rewards" as "egregious examples of an economic ethic that places economic gain above all other values".

From this perspective, individual miscreants are at the heart of the problem and lowering their potential incomes would give us preferable economic outcomes.

However, the emphasis on personal greed misses two points. It fails to recognize the impact of institutional arrangements which pressure executives to put an increasingly higher priority on short term business outcomes, no matter what their incomes are going to be. Secondly, it falls into the trap of attributing the instability which comes with

group outcomes to individual behaviours and does not give enough weight to the inherent tendency of a market economy to instability if not appropriately regulated.

To make progress toward a better system, we need to confirm, first, whether Fuld is the problem or simply a manifestation of a systemic instability and, to that extent, a distraction.

The argument that Fuld and his peers are the problems rests on the following proposition: that the underpinning of our economic system is so flimsy that it is unable to withstand such payments no matter how ill deserved. But surely \$250 million (or even some multiple of that) could not have brought global capitalism to its knees?

The world is awash in outsized financial transfers to self indulgent individuals and institutions adding only ambiguously, at best, to our social or material welfare. The US National Aeronautics and Space Administration (NASA), to pick on just one unsuspecting bystander, has a budget of US\$17 billion of public money for 2009. Over the same time as Fuld allegedly received \$500 million, NASA spent over \$120 billion in a largely self indulgent exercise, rooted in the cold war and promoted by a relative handful of people quixotically pursuing life on other planets. Meanwhile, payments of tens of millions of dollars over seven or eight years are, regrettably, commonplace among elite athletes and popular entertainers.

But their gains have not crippled our economic system in the way that Fuld's windfall is supposed to be damaging it. There must be something more.

Adolph Berle and Gardner Means published their pathbreaking work on modern capitalism "The Modern Corporation and Private Property" in 1934 amidst the clearest failure of the market economy and at a time when, in the minds of many, there was a

viable alternative based upon Karl Marx's critique of capitalism and related experiments with central planning. In that book, they noted how the nexus between corporate ownership and management had been broken and explored some of the implications for a new form of capitalism that had emerged from the change. In November 1959, Berle wrote an article for the New York Times entitled "Marx was Wrong and So is Khrushchev" in which he extended his views about the corporation to explain its important role in the survival of capitalism and the failure of the revolution Marx had anticipated.

He put forward three reasons for the failure of the Marxist revolution to eventuate. The first was the arrival of the corporation in which the tycoons and moguls who had so raised Marx's ire were substituted with professional managers. The second was the rise of labour unions which did not attempt to assert ownership of productive assets but chose, instead, to represent workers from outside the corporate structure. The third was democratic government which declined to pursue the interests of the business tycoons in the way in which Marx had forecast them doing so.

Berle identified an important distinguishing characteristic of the new corporation: in contrast to the firms Marx had observed "it did not behave at all like a personal fortune-builder". But for this, the collapse of capitalism would have been more likely.

This distinguishing feature is no longer so evident. Corporate governance experts in the 1980s and 1990s concluded, in their wisdom, that executive ownership would enhance the performance of corporations and they set about restoring the link between management and ownership whose elimination eight or ten decades earlier, according to Berle, had saved capitalism.

More and more executives were given shares or options over shares and a share of corporate income as part payment for their management skills. A new power elite emerged as ownership and management were reconnected. In an era of rising equity markets, executives could once again acquire extreme wealth if they succeeded in

delivering corporate growth and even, sometimes, if they did not.

Like Marx's stereotypical tycoon, these modern day managers are now attracting a disproportionate amount of attention. In reacting to their wealth rather than the reasons for it, we might also diagnose wrongly the underlying sources of our market instability.

Unlike the autocratic business owners of the nineteenth century, the modern day owner-managers of large corporations lack discretion to ease up on the pursuit of profit even if they were of a mind to do so. The structure of payments, among other constraints, limits their freedom to pursue non-profit goals.

The threat of termination evident in shortening executive tenure alters the timescale on which managers must lock-in their successes. Pursuit of short-term gains is increasingly a matter of survival rather than personal greed.

Many executives would prefer it were otherwise but, like rats in a laboratory maze, their choices have been deliberately limited. Their behaviour reflects their training to find the way out irrespective of the size of the piece of cheese at the exit.

Paying an executive a relatively small but guaranteed \$100,000 cash salary according to a secure long term employment arrangement, as was commonplace in the 1960s, will potentially deliver a different outcome than if the same person is paid \$100,000 in share options for a specific result to be measured over, say, 18 months and where the ultimate wealth of the recipient will be driven by short term movements in share prices.

The amounts are less important than the way they are paid in affecting the behaviour of the modern day manager. Individual managers have little control over this payment model which has gained rapid and widespread acceptance.

Giving managers and even junior employees an economic interest in the performance of the corporation in which they work was applauded when viewed from the

perspective of a single firm. The move was supposed to make firms work better both financially and socially. It would reduce worker alienation. And, yet, a well intentioned change extended widely has given us results now labelled "scandalous".

In analysing markets, an important distinction needs to be made between the impact of a single individual or entity on the overall welfare of the community and the impact of a group of individuals behaving in exactly the same way. In a market context, commendable individual behaviour might not be beneficial for the community if duplicated by everyone. An undesirable economic outcome might not be due to undesirable individual behaviours.

Let's take an example. A local bank is persuaded by a group of community church leaders that it should support efforts to reduce global poverty by allocating a small proportion of its loans to foreign governments in developing countries to enhance their access to capital for needed infrastructure. This bank with assets of \$20 billion, say, decides to allocate just \$100 million to developing country loans on commercial terms. The recipient countries are unambiguously better off as they put the loans towards important infrastructure projects. The overall risk profile of the lending bank is barely altered. Its income is enhanced. Both borrower and lender are better off.

This single bank's activities are highlighted in the popular press as well as in the financial media. Its reputation grows and church leaders elsewhere urge a similar course on other banks in their respective communities. Bank loans to developing countries proliferate and there are soon more than one thousand banks lending \$100 million each.

Some banks see this as a potential area of specialization. They lend a growing proportion of assets to developing countries. One becomes a leader in the field. When its chief executive was hired, the board of directors wanted to give him an incentive to succeed. They offered him a payment of 0.5% of the value of new loans generated to developing countries but he would receive nothing if he did not lend at least \$100

million. No bank had lent more than that before. By taking the job, he risked not having any income. But his organisational skills and the rapport he had with the people he worked with were exceptional. Neither he nor the board had anticipated that the bank's loan book would grow to \$3 billion over five years entitling the CEO to an individual payment of \$15 million, the most that had ever been paid to a banker before.

Then, unexpectedly, there is a military coup in one of the developing countries. The new leaders announce they will not repay their bank loans equivalent to just 3% of the total outstanding around the world. Accounting authorities, nonetheless, demand that all loans by all banks be revalued to take account of the greater possibility of other countries acting similarly. Some banks have to raise new capital to compensate for the reduced value of their developing country loans locking in losses among all the superannuation funds that had invested in them before. There is a community backlash. The market leader fails. Its CEO is pilloried by the press.

At what point in this chain of events have good intentions given way to greed and immoral behaviour? Were the church leaders misguided in the first place? Should the first bank in the chain have been blocked from lending overseas? If not the first, how many should have been permitted to lend and how many excluded? Was there something immoral about an executive incentive payment which should have been disallowed by the government and decried by church leaders?

Here's another example. Well meaning people would most likely agree that, as far as possible, everyone should have access to housing of a reasonable standard. If one bank came up with a mechanism to make it possible to create housing loans for an additional 5% of its lower income customers while keeping the bank within acceptable prudential standards, the community would probably endorse the idea, congratulate the bank on its innovation and accord it a higher standing in the community.

Then, let's say, a group of U.S. senators becomes so enthused at the possibility of more people having access to housing that

they sponsor legislation supporting the initiatives of local banks, offering loan guarantees when the loans are to people with incomes less than \$50,000. They actually go a little further. They change the rules to encourage the banks to lift the proportion of loans from 5% to 10%. The community endorses this wholeheartedly re-electing the senators responsible with thumping majorities. The next session of Congress abolishes the 10% limit so enthusiastic is everyone about the benefit.

So far so good but a completely unanticipated fall in housing prices in Florida after a spate of overbuilding means that banks have to reduce the value of the loans they have made and some are threatened with failure unless they can rapidly raise fresh capital.

Again, the same question: was this always ethically suspect behaviour? If not, at what point have good intentions given way to immorality? Where is the line to be drawn? Or is it not an ethical question at all but, rather, a technical economic question of how much lending was appropriate to maintain the right balance of the economic system in which the banks operated?

These are only slightly idealized examples of how entirely acceptable actions by one person or a single organization risk destabilizing the financial system if they are widely duplicated.

To be sure, greed might be a driver for some individuals but, even with the best of motivations we could end up with an unstable market regime, susceptible to unanticipated shocks, as individually accepted actions are reproduced more widely.

This makes for a very complex economic, moral and political set of choices that potentially run contrary to some fundamental beliefs about what a government can do in a liberal democracy. It also runs contrary to the moral precepts which underpin many of our community standards.

Our Christian teachings on which our views of equity are based, for example, tell us to treat all our neighbours as we would have them treat us. There is no scope for

moderation. We are not told to treat 10% of our neighbours as we would have them treat us; 35% of our neighbours slightly less well and the remainder with indifference. But that is what is required to maintain the stability of a market based economy.

At any point in time, a functioning market needs a balance between buyers and sellers. In other words, it needs people taking contrary views about prospective circumstances and what might be in their best financial interests. It fails, as we are seeing, when everyone tries to sell or everyone tries to buy or no-one wants to lend or everyone is prepared to lend with little regard to the risks.

Absence of greed might not be sufficient to prevent market instability. Market stability is more likely to be accompanied by diverse behaviour even if driven entirely by greed.

However, group behaviour is increasingly a feature of modern markets in which sophisticated telecommunications spread news with lightning speed forcing equally fast responses to economic and political events which might affect market values. Taking time for considered independent judgement is itself a risk in markets that are moving quickly and in which single individuals, no matter how greedy, have little effect.

Like the crowd at the football, market participants all rise instinctively in response to the action on the field. For some, envy plays a role but there is also a strong element of feeling comfortable in the company of others. Few of us are innovative enough or confident enough in our own judgements to move against the prevailing view. For the vast majority, the safest course is to follow others.

Failing while all those around you are failing for the same reason is easier to take and does less damage to personal reputations than failing conspicuously through one's own poor and unique judgement. But, like everyone running to the same side of the boat at once, following the lead of others risks destabilizing a fragile craft.

For the market to operate sustainably, we want some banks to develop products which

might extend home ownership. But not all. We want some banks to look at innovative ways to recycle investible funds to developing countries. But not all. Recombining management and ownership in a limited way might provide benefits in some instances but, done across the board, it can remove one of the distinguishing features of our economic system the absence of which threatens its downfall.

Market stability, in practice, might require that some economic agents, whether individuals or corporations, are accorded rights which are not accorded to others. Some can be allowed to move to the port side of the boat. For the sake of stability, others might have to stay where they are. Taken to its logical conclusion, this suggests a degree of government intervention in economic decision making akin to a system of central planning.

The reputation of central planning, however, is so poor that it is not even discussed as a policy option any more despite governments in liberal democracies becoming day-by-day more than ever engaged in allocating capital in accordance with their own judgments about where it should go. New names are being coined daily for their newly created roles but never 'central planning'.

The contradiction between the market's inherent tendency to instability if left to operate unconstrained and the welfare of the broader community leaves us in a policy and moral no man's land.

We can act against individuals moving to the other side of the boat to ensure that no one ever moves again without permission but only at the risk of stifling innovation and individual initiative. Just as central planning in China and the Soviet Union showed, opportunities are missed, innovation becomes less frequent and overall wellbeing suffers when having to wait for instructions from the chairman of the central planning committee or his surrogates.

Confronted with this choice, governments of liberal democracies and their electors have opted for a hybrid model with the balance tilted very much toward letting people move to whatever side of the boat they choose. Only when the economic boat is listing

noticeably are they inclined to intervene. But such a model leaves us prone to periodic threats of sinking which must be averted in an emergency.

None of this should be taken as an apology for \$100 million-plus remuneration packages or other forms of excess displayed by Fuld and criticized by Rep. Waxman and the U.S. bishops. These remarks are, however, intended to highlight the need for more clarity in deciding what is important in framing policy.

The behaviours currently bedeviling our economic institutions might be far more subtle and complex than understood by many of our religious and political leaders who have seized somewhat simplistically on greed among a few high profile bankers as the primary cause of our distress. They risk taking us down a track which, at best, will waste time. More worryingly, this route also risks policies which could damage the longer term functioning of our economic system while possibly inflaming a new set of class tensions by highlighting the modern day mogul as the source of our misery.

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