

WHITE PAPER NO. 44



The Financial Crisis and the
Collapse of Ethical Behavior



GREYCOURT

White Paper No. 44 – *The Financial Crisis and the Collapse of Ethical Behavior*

Most assessments of the financial crisis that began in August of 2007 identify as the source of the problem such issues as poor risk controls, too much leverage, and an almost willful blindness to the bubble-like conditions in the housing market. Well, maybe. These issues were certainly the proximate causes of the crisis we find ourselves in, and if only one or two firms had drunk the Kool-Aid – a Drexel Burnham, let’s say, or a Long Term Capital Management – we could buy the usual nostrums as the full story.

But we suspect that the financial firms and their executives aren’t quite so collectively stupid as this explanation would imply. We think there was something else going on, something that allowed intelligent people to persist in unintelligent behavior. In our view, poor risk controls, massive leverage, and the blind eye were really symptoms of a much worse disease: the root cause of the crisis was the gradual but ultimately complete collapse of ethical behavior across the financial industry. Once the financial industry came unmoored from its ethical base, financial firms were free to behave in ways that were in their – and especially their top executives’ – short-term interest without any concern about the longer term impact on the industry’s customers, on the broader American economy, or even on the firms’ own employees.

By a collapse of ethical behavior we mean exactly what we say – that the actions of many, if not most, of the large American financial firms (and of the many foreign firms that succumbed to the “American disease”) would strike an ordinary person as unethical – repulsive and scurrilous. But we also mean something more specific to the long-term viability of the financial industry, namely, the disappearance of any sense of fiduciary responsibility to the ultimate client.¹ Integrity and a sense of responsibility to the industry’s customers are at the core of what a financial industry must be all about; otherwise, it’s just a big Ponzi scheme.

An Unsavory Rehash of Recent Ethical Failures

Painful as it is, let’s take a quick look at some of the moral and ethical failures of the financial industry, focusing on those that led directly to the current financial crisis.

Ethical failures in subprime lending

Back in the day, people obtained their mortgages from their local banker, whom they likely knew personally. The banker held the mortgage paper on his balance sheet, and hence cared very much whether the paper was good. That was inefficient, of course, so matters began to evolve rapidly. By the 21st Century the system worked like this:

* Mortgage brokers developed to find borrowers. Since these brokers were paid on quantity (“How many mortgages did you bring me today?”), not quality (“How many good mortgages did you bring me today?”), and since they weren’t carrying the paper on their own balance sheets, far too many of the brokers cared not at all whether the borrowers were engaging in thoughtful transactions or were being set up for heartbreak and penury. Once a mortgage was approved, the broker got paid and would never see the borrower again. To say that very large numbers of mortgage brokers behaved abominably is merely to state the obvious.

* Banks approved the mortgages after (maybe) reviewing the applications, but the banks had no intention of holding onto the paper. Instead, they needed to build leverage into their balance sheets, which meant getting this paper off the balance sheet as quickly as possible.² (The paper was sold into mortgage pools that were in turn sold to unsuspecting investors.) Underwriting standards declined and eventually disappeared altogether. Did the banks care whether their shoddy practices resulted in lending money to people who couldn’t possibly pay it back? Did the banks care what was likely to happen to the ultimate investors in this paper? Not likely. In fact, commercial banks scrambled to acquire subprime lending banks so they could get ever more deeply into this seedy game.

* Because banks wanted to leverage their balance sheets (re-using their lending capacity over and over again), a market developed for pooled mortgages. Fannie Mae and Freddie Mac and the various megabanks and investment banks put these pools together and then sold them on to investors. Did the financial firms care about the quality of the paper they were selling, or the possible harm to investors who bought it? No, this was a volume operation: the more pooled vehicles the firms could form and the more they could reduce their costs (i.e., no actual checking on the quality of the paper), the higher the profits. What about the consequences for the end investors, many of whom were loyal, long-term clients of the financial firms?

* And what about the rating agencies, the last line of defense between a scamming industry and the ultimate investors? Turns out that conflicts of interest were so rife in the industry that at least one state attorney general is investigating the “symbiotic relationship” between the agencies and the banks and investment banks whose securities they were supposedly rating objectively.³ Were the ratings agencies in the pockets of the financial firms, essentially selling their ratings to the highest bidder?

After a few years of this, is it any wonder that the subprime business blew up, destroying investor capital, wreaking havoc with the lives of over-leveraged borrowers, and destroying confidence in the institutions, individuals, and regulatory agencies that not only allowed all this to happen, but in many cases actively cheered it on?

Ethical failures among the subprime lending banks

We think it likely that there is a special circle in hell reserved for subprime lending banks like Countrywide Financial, which were at the epicenter of the subprime collapse, and at the epicenter of the ethical collapse. Looking back, it's clear that the main *raison d'être* of the subprime banks was to sell mortgage loans to people who couldn't afford them. Screaming ads were created to dupe people into applying for these mortgages, and new, highly misleading mortgage products were developed (teaser rates, Alt-A, etc.) to ramp up volume. Mortgage brokers were paid big fees to lure a steady stream of suckers into the scheme. There was a time when this would have been seen for what it was: predatory lending.

Strangely enough, prior to Countrywide et al., there had been a long and reasonably distinguished history of subprime lending in the US. But here is the interesting point: prior to Countrywide, lenders to less-than-prime borrowers employed *more* intensive underwriting, not *less* intensive underwriting, before making their loans. Loans to less credit-worthy borrowers require more careful background checks, more complex structuring, different legal, collateral and repayment conditions, and so on. Countrywide and others substituted volume for hard work, giving the entire subprime lending industry a bad name.

We single out Countrywide both because of the scale of its subprime lending activities and, especially, because of the egregious conduct of its CEO, Anthony Mozilo. Mozilo didn't build his huge personal fortune because he was smarter or harder-working or more creative than other financial executives, nor even because he was luckier than others. He built it on predatory lending and by buying influence in high places. We described the predatory lending activities of Countrywide above, so let's turn to the sordid business of currying favor. It is now clear that Countrywide attempted to suborn the support of key politicians, regulators, and other influential figures via a secret internal program (headed by loan officer Robert Feinburg, now a whistleblower) that offered below-market terms on mortgages to individuals Countrywide wanted to curry favor with. This VIP-loan underwriting unit handled mortgage applications from what was known inside Countrywide as "Friends of Anthony," that is, important figures Mozilo wanted to have in his pocket. The known list of "bribees" is still growing, but so far it includes US Senators,⁴ former Cabinet officers,⁵ Fannie Mae CEOs,⁶ judges,⁷ and many others.⁸

Ethical failures in auction rate securities

To understand just how egregious the ethical failures were among the (many) financial institutions that sold Auction Rates Securities (ARS) to their clients, let's back up and look at the nature of ARS. The idea behind these securities was to create an instrument that would have a long-dated maturity but an interest rate similar to very short-term paper. This was attractive to municipalities and large nonprofit institutions that issued bonds, and it would also be attractive to individuals and institutions who wanted a cash-like risk level but a higher yield than cash. The way it worked was that a long-dated tax-exempt bond would be issued that would pay an interest rate determined by Dutch auctions held (usually) weekly or monthly.

Banks and investment banks eagerly structured such bonds on behalf of municipal clients, and even more eagerly hawked them to investors. Typically, an investor would receive a cold call from his broker, who would tout the exceptional benefits of ARS: "Safe as cash but with a higher yield!" The trouble was that ARS were "safe as cash" only so long as the periodic auctions were successful. If an auction failed, the issuer would pay a much higher penalty rate and the investor in the security would find that his funds were frozen. Some cash!

To ensure that the auctions wouldn't fail, the banks and investment banks agreed to support the auctions by stepping in if there weren't enough bids. In other words, regardless of what the fine print in the underwriting agreement said, the municipalities issuing ARS and the investors buying them clearly expected the banks to stand behind the paper. If there was no expectation that the banks would do so, then there could be no claim that the paper was safe. Thus, the ethical issue was clear from the outset: either the banks had no obligation to support the auctions and hence the paper was very risky, or the banks did have such an obligation and the paper was safe.

We aren't suggesting that the financial firms intended to rip their clients off from the beginning, but we *are* suggesting that when the going got slightly tough (and after making big profits on ARS for years), the banks bailed, leaving their clients in the lurch. Specifically, the banks wanted to have their cake and eat it, too: make money structuring the bonds and auctions and make more money selling ARS to investors, then abandon their clients when trouble first reared its head. The financial firms stood by and allowed ARS auctions to fail, causing issuers to pay egregious penalty interest rates and causing investors' funds to freeze up.⁹ Both the issuers and the investors were long-term clients of the banks.

Ethical failures among the GSEs

GSEs are Government Sponsored Entities like Fannie Mae and Freddie Mac.¹⁰ They are – let's face it – bizarre combinations of private corporations and Federal bureaucracies. They are shareholder-owned corporations whose shares trade in the public market, but they were formed by the Federal government and their credit is backed by the government. The GSEs have been political footballs for many years, with (we simplify) Democrats defending them for their role in making housing affordable and Republicans vilifying them for usurping what should be the job of the private markets.

But let's sidestep the political heat and simply note that the role of the GSEs is simplicity itself: using their government backing to borrow cheaply in the markets, the GSEs buy mortgage loans from banks, securitize these loans and sell them to investors. Once the loans are off the banks' balance sheets, the banks can make more loans. (Thereby making mortgage loans more widely available.) What a great racket! The investors who buy the mortgage-backed securities bear the interest rate risk and the taxpayers bear the default risk. What is it, exactly, that the GSEs bear? That's right – nothing! A ten-year-old could run Fannie Mae and Freddie Mac and not make a hash of it, to say nothing of, say, a GS-13 government bureaucrat.¹¹ So how was it, exactly, that the CEOs of the GSEs screwed them up so badly?

The specific problem was that the GSEs tried to increase their profitability by not just buying loans, bundling them and selling them, but also by holding billions of dollars worth of these mortgages on their own balance sheets. Anticipating how credit-challenged borrowers will behave, how housing prices will behave, and how these factors will affect the value of complex mortgage paper isn't a game for 10-year-olds or for G-13s, and, as it turned out, it certainly wasn't a game for the ethically-challenged CEOs of Fannie Mae and Freddie Mac (who leveraged these institutions' balance sheets 75-to-1). When the loans went bad, both the revenues and the balance sheets of the GSEs collapsed, and that was the end of them.

In any event, the more fundamental problem lay in the queer nature of these entities, half publicly held corporations and half Federal bureaucracies, and in the ability of the senior executives to manipulate this hybrid nature to their own advantage. Thus, in their role as publicly held corporations the GSEs mainly behaved like government bureaucracies, and in their role as government bureaucracies they mainly behaved like publicly held corporations. The subprime debacle was a perfect example of this. When private firms began to make large numbers of loans to subprime borrowers, that should have been welcome news to a government bureaucracy – the private sector was stepping up to the plate, making housing more widely available, so there was no need to put taxpayer money at risk.

But the CEOs of the GSEs didn't see it that way. In their government bureaucrat role (making housing available) they behaved instead like private corporations, insisting that they couldn't lose market share. ("There goes the value of my stock options!") But in their publicly held corporation role, once subprime came unglued the CEOs behaved like government bureaucrats, running to Congress for protection from the heat coming their way.

Indeed, since the mission of the GSEs is so simple, it's much more instructive to think of them not as players in the mortgage markets, but simply as Get Rich Quick schemes for their senior executives. Thus greed-fueled executives like Franklin Raines,¹² Leland Brendsel,¹³ Daniel Mudd,¹⁴ and Richard F. Syron¹⁵ made huge fortunes managing a completely risk-free operation. They hobnobbed with politicians in Washington to protect their sinecures and shamelessly pandered to public opinion with pious claims about their roles in keeping housing affordable. In fact, the GSEs under these executives so badly mismanaged themselves that the housing market has collapsed, thousands of homeowners have been thrown into the streets, and the taxpayers are about to be on the hook for billions of dollars to bail these blockheads out. Meanwhile, as noted, the executives got vastly rich.

The contemptible public disclosures of financial firms

Publicly held firms in the United States have very strict obligations when it comes to making public disclosures. Among the more important obligations is to report material events in a timely and accurate way and to avoid making overly rosy claims about their business and financial condition. Failure exposes a firm and its executives to shareholder lawsuits and to SEC fines and penalties. But has anyone been listening to the public disclosures made by financial firms over the past year? Over and over again we were treated to impossibly optimistic statements from CEOs of financial firms, statements that were clearly designed to lure shareholders and customers into a false sense of security. Jamie Dimon of JP Morgan Chase told investors at the Investment Company Institute in May that the worst of the credit crisis "was 75% to 80% over." Lloyd Blankfein of Goldman told his shareholders at their annual meeting in April that "[W]e're at the end of the third quarter, beginning of the fourth quarter" of the crisis. At his own shareholder meeting, John Mack, CEO of Morgan Stanley, said "You look at the subprime problem in the U.S., you would say we're in the eighth inning or maybe the top of the ninth." More recently, even as the crisis was deepening, Josef Ackermann, CEO of Deutsche Bank, assured investors that the credit crisis was at the "the beginning of the end."¹⁶

Perhaps the best example of all occurred between December 2007 and September 2008 at Lehman Brothers. Late last year, Lehman's CFO assured the public that the firm was in fine shape and certainly wouldn't need to raise additional capital. The echoes of this breathtaking claim had barely died away when Lehman raised \$6 billion(!) of additional capital, profoundly diluting the existing shareholders, who had just been assured that all

was well. Despite frequent and ongoing assurances from Lehman's CFO and CEO that all was well, the firm continued to spiral downward, failing completely in September 2008. Were the Lehman executives, and those quoted above, simply delusional? Or were they engaged in something more disreputable, i.e., lying to the public, to their customers, to their investors, and even to their own employees? Yet the regulators sat on their hands. So far as we know, the only firm that has been disciplined was a small company listed on London's AIM market, which was fined \$150,000 (£75,000) for making "unrealistically optimistic statements."

Shorting the securities you are selling to your clients

Quite possibly the single most egregious example of unethical conduct in the financial industry was the practice of aggressively selling subprime debt-loaded mortgage paper to clients of a firm, while simultaneously and secretly shorting that paper for your own proprietary capital. The prime blackguard appears to have been Goldman Sachs, which noted in its 3Q07 quarterly report that, "Significant losses on non-prime loans and securities were more than offset by gains on short mortgage positions." It's possible – bizarre as it sounds – that this practice isn't illegal if you are an investment bank, but it is certainly disgraceful. If Goldman were, say, a Registered Investment Advisor, and was selling subprime paper to its clients while secretly selling that paper short for its own account, the firm would be shut down by the regulators and its executives banned from the industry. But Goldman not only got away with this practice, but actively brags about how smart it was.

Paulson Bernanke & Co. and the conspiracy of silence

The question naturally arises: while all this (and more) was going on, where was the US government and its appointed regulators? Don't they exist to advocate the interests of consumers and investors against the combined might of the financial industry? And isn't it an important part of their responsibilities to head off trouble *before* it happens, rather than trying to clean up the mess afterward? And yet, from the beginning of the crisis in mid-2007 (and even long before), these folks have either been active cheerleaders¹⁷ for a financial industry whose actions should have been repulsive to them, or they have kept quiet and averted their gaze as one scurrilous activity after another paraded across the front pages.

Let's be clear – we're not complaining of the actions PB&Co. have been taking once the industry's unethical conduct began causing meltdowns of important companies. History will be the judge of that. But long before the companies collapsed the Feds kept quiet and kept invisible. Where were they during the ARS scandal? It was the state attorneys general who knew a fraud when they saw it, while the Feds sat idly by. Where were the Feds when Goldman Sachs was secretly shorting mortgage debt it was aggressively selling to its

customers? Where were the Feds when the GSEs were abusing their birthrights and mismanaging themselves into oblivion? Where were the Feds when financial firm CEOs and CFOs were lying to investors?

And where, most prominently, were the Feds while the financial firms were leveraging themselves into almost certain oblivion? PB&Co. claim to have been blind-sided by the collapse of the entire investment banking industry, but if so it was an intentional refusal to see what was happening before their eyes. We have four words for them: Long Term Capital Management. Ten years ago LTCM over-leveraged itself and so terrified the New York Fed that it organized a hasty¹⁸ rescue – not of LTCM and its investors, who were wiped out, but of the many other financial firms who had eagerly traded with LTCM on the way up and now didn't want to take their medicine.

We've had ten long years to figure out what went wrong at LTCM and how to ensure that it wouldn't happen again. What were PB&Co. (and their predecessors) doing during those ten years? They are like modern-day Rip Van Winkles, suddenly awakening in 2008, looking around and saying, "How could this have happened?"

A poor taxpayer might be inclined to think that the Feds cared far more about Wall Street than about Main Street as we were treated to the following spectacles:

- * The bailout of Bear Stearns (taxpayers on the hook for at least \$29 billion).
- * The bailout of Fannie Mae and Freddie Mac (taxpayers on the hook for God-knows-what, but many billions).
- * The banning of so-called "naked shorting"¹⁹ *just for a handful of favored financial firms*, and eventually the banning of short selling for all financial firms in the US. (But not, of course, for non-financial firms.)
- * The opening of the Federal discount window for "dealers" (investment banks) for the first time since the Depression.
- * The bailout of insurance giant AIG, by guaranteeing \$85 billion of obligations. (This was recently raised by another \$38 billion – pretty soon will be talking about serious money.)
- * The \$50 billion bailout of money market funds.
- * The (so far) \$700 billion bailout of every financial firm that has toxic paper on its balance sheet.

However important the TARP legislation might be, is it any wonder that public opinion was so solidly opposed to it that the House of Representatives first voted it down?

How Scandal Became Crisis

That large financial institutions ought to behave in an ethical manner seems perfectly obvious. But how bad behavior lay at the core of the current financial crisis may not be so apparent. We suggest that the medium of transmission from scandal to crisis followed two paths: loss of trust and abandonment of customers.

Trust

When a corporation behaves ethically, it might be functioning well or poorly, and it might be a good or bad firm to invest in, but at least we know how it will behave: it will obey the law, treat its employees respectfully, be honest in its public disclosures, honor its commitments, be a good citizen in the communities where it operates, and so on. But when a corporation (or, God help us, an entire industry) behaves badly, we have no idea what to expect. One day they are shoving mortgages down our throats and the next day you can't get a mortgage to save your life. One day they are standing behind ARS auctions and the next day they are nowhere to be seen. One day they are honestly disclosing their financial condition and prospects and the next day they are lying through their teeth. One day they are innocently selling us subprime paper and the next day they are quietly shorting that paper behind our backs.

Financial firms, much more than other firms, live and die on trust. The very definition of a bank is a firm that borrows short and lends long. A bank might take customer deposits – offering customers instant liquidity – and loan them to people who want 30-year mortgages. An investment bank might borrow in the overnight market and make trades that won't unwind for weeks or months. So long as people trust the financial firms, all is well. But once trust evaporates the jig is up – there is no way a bank can call in long term assets to pay off the short term demand.

Unethical behavior in the financial industry eventually became so widespread that trust evaporated – no one could possibly know what firms in the industry would do next, and so no one would play ball with anyone in the industry. This caused the failure of the weakest, most leveraged, least-trusted firms, and it caused commerce to freeze up for firms that were stronger but still distrusted. If the Abu Dhabi Investment Authority liked Citi in November of 2007 at \$35/share, they must love Citi at \$14/share now, right? Wrong. The ADIA thought it was buying into an international brand name that had been temporarily hurt by declining housing prices. But as time has gone by, the ADIA has realized that it has no idea what it bought, and it isn't very happy about that. Trust has been broken and Abu

Dhabi's checkbook is closed. Even inside the industry banks won't lend *to each other* because they believe that everyone is lying about its own financial condition. Thus does a breakdown in trust lead directly to a financial crisis that cannot be fixed until trust – not just capital – is reestablished.

Customers

The disappearance of any sense of fiduciary responsibility to the financial industry's customers caused the industry to become unmoored. So long as financial firms felt an obligation to their clients, there were serious limits on how bad their behavior could become. But once they learned that customers could be treated badly and the only consequence was that profits went up, the industry went straight to hell in a handbasket. Mortgagors, buyers of ARS, shareholders, bondholders, owners of subprime paper, and wealth management clients were all abandoned by the industry, and along with that abandonment went any limits on how the firms might behave. As we noted above, a sense of responsibility to its customers is the only legitimate reason for a firm to exist. Once the customers walk – and they have walked away from the financial industry in gigantic numbers – the industry is doomed in its existing configuration. The current financial crisis won't be resolved until customers believe that their interests will be served by the financial industry of the future.

Why Such an Ethical Swamp?

Each of the scandals described above has been widely covered in the general and financial press. But what hasn't been so much commented on is the *pattern* of behavior, the cascade of scandal upon scandal, the consistency of ethical lapse unknown in any other industry.

We've spent considerable chunks of our professional careers in other industries – law, business, the non-profit world, and so on – so we can say from first-hand experience that the private moral character of financial industry professionals is no better or worse than that of people in any other industry. So why is the financial industry so prone to scandals, such a positive disgrace to American industry and the free market system in general? It's a bit of a mystery, to be sure, but here are some suggestions.

Hedge fund wannabees

Investment banks are, technically, broker/dealers, and for roughly a century the emphasis was decidedly on the “broker” aspect. A broker isn’t a principal in a transaction, but an intermediary, a facilitator. If a Merrill Lynch broker convinced his customer to sell IBM and buy GE, he made a commission on the transaction but wasn’t a principal in it. IBM, GE and the customer could all go broke and the broker wouldn’t be affected.

But by 1975 customers had had enough and commissions became negotiable. With the advent of competition, overall commission rates declined,²⁰ as did the revenue broker/dealers received from that source. In 1965, for example, broker/dealers earned 61% of their revenues from commissions, but by 1990 this had dropped to 16%.²¹ Most of the wirehouses went out of business or fled for safety to banks and investment banks – Smith Barney to Citigroup, Paine Webber to UBS, Dean Witter to Morgan Stanley, and so on.

Since broker/dealers had to look elsewhere for revenues and profitability, they stopped being mainly brokers and became mainly dealers. Unlike a broker, a dealer is a principal, risking its own capital. There is nothing wrong with being a dealer, of course, but heeding the Wall Street axiom that “if some is good, more is better,” the broker/dealers – now mainly dealers – began to add significant leverage to their trades. In the mid-1970s broker/dealers operated with leverage of about 6x.²² In other words, they had 16 cents of equity for every dollar of risk. But by 2006,²³ broker/dealers were operating with about 30x leverage – they now had only 3 cents of equity for every dollar of risk.²⁴

In other words broker/dealers had become very large hedge funds. Executives at broker/dealers had long envied the compensation earned by the best hedge fund managers, and eventually they succeeded in converting themselves into exactly that: gigantic, massively leveraged hedge funds. For example, in 2007 Goldman Sachs generated 68% of its revenue not from commissions or investment banking, but from proprietary trading.

As everyone knows, hedge funds are private partnerships, and if the manager of a hedge fund behaves stupidly – leveraging his fund 30-to-1, for example – his investors will get wiped out. But so what? It might be a private tragedy for the hedge fund manager and his investors, but it’s hardly a matter for public concern.

One of the reasons the activities of individual hedge funds aren’t matters of broad public concern is that *hedge funds don’t have clients*. But investment banks that are hedge fund wannabees *do* have clients, and unfortunately those clients are often on the other side of trades made by the banks’ prop desks. If a hedge fund wants to short subprime paper, it might be a good or bad idea but it isn’t an ethical issue. But when an investment bank shorts paper it is simultaneously selling long to its clients, the bank has sunk so deeply into a moral swamp that there is no getting back out. Moreover, as everyone knows, prop desks

at banks routinely front-run client positions which the bank learns about precisely because these investors are clients of the firm's investment banking, wealth management, or capital markets groups.

Finally, unlike hedge funds, investment banks very much *are* a matter for public concern, in these very direct senses: their shareholders include ordinary American investors (not just high net worth folks), and their activities are so vast, their influence on the broad economic world so crucial, and their inter-connectedness so extreme that they can rarely be allowed to fail. Thus, American society finds itself in a world where “heads, the investment banks win,” and “tails, the taxpayers lose.” If the wild risks investment bankers take pay off, they make millions; if the risks collapse, taxpayers bail them out. It's not just a stupid way to run an economy, its morally abhorrent. If taxpayers are going to have to bail institutions out of their own cupidity, taxpayers need to set the rules under which those institutions can operate.

“When the music plays you have to dance”

With these memorable words Chuck Prince, the now-deposed CEO of Citigroup, ran his company into the dumpster. Prince was saying, in longer words, something like this: “Look, pal, I know perfectly well that I'm stuffing my own balance sheet full of toxic waste and that all this nonsense can only end badly. But everyone else is doing the same thing and making tons of money doing it, so if I don't do it my board and shareholders will have my scalp.”

Prince was possibly right – financial firm boards and shareholders were all enthusiastic participants in the let's-make-hay-today-and-to-hell-with-tomorrow follies. But did Prince ever stop to think about whether it was the right thing to do? Did his board pay him tens of millions of dollars to act like a lemming? Somewhere along the way, somewhere in all the muck of greed and breach of fiduciary obligations and the to-hell-with-the-customers attitude, Prince lost his moral compass. And he was in good company across the entire industry.

Compensation follies

American industry in general has a serious problem with the compensation of its senior executives. Time after time, a CEO runs his company into the ground, devastating shareholders and employees, then glides off into the sunset sheltered by his golden parachute.²⁵

But bad as the general run of publicly held companies are, the financial institutions are much, much worse. Exactly why this should be so has been the subject of much commentary. It has been pointed out, for example, that while a typical corporation pays out

about 25% of its gross revenues in compensation, financial firms can pay out as much as 60%.²⁶ But this can't be the full answer, since many firms in service industries pay out similar percentages of revenues in compensation (law firms, public accounting firms, consulting firms) but don't pay the scandalous compensation observed in the financial sector.

We think financial firms are driven by an unusual combination of circumstances: they are characterized in spades by the greed and short-term incentives that too-often dominate compensation at the top of other publicly held corporations. But they also have access to massive leverage, which magnifies both the upside of their risky behavior and also the downside. Thus, a run-of-the-mill public company CEO might use short-term tactics to boost his firm's quarterly earnings and therefore his compensation, only to see the earnings fall apart a few quarters later. He has already banked his winnings and laughs all the way to the bank. At financial firms, short-term tactics, accompanied by massive leverage (thoughtfully made available by PB&Co. and their predecessors) produces *huge* short-term profits and *huge* short-term compensation. But when the wheel turns it's not just that quarterly earnings sag – it's that the firm files for bankruptcy or is bailed out by the taxpayers.

The financial firms, which could have used cash flow to improve their products and services, or at least distribute it out in dividends, instead allocated that cash flow to compensation, especially for top executives. The contrast between the staggeringly high compensation paid to, and the breathtaking incompetence exhibited by, financial firm CEOs, is almost beyond belief. Stan O'Neal was paid \$172 million at Merrill to drive the firm into the ground. James Cayne was paid \$161 million to (reportedly) play cards, go golfing and smoke dope while Bear Stearns collapsed. By the end of 2007 Richard Fuld had already made most of the mistakes that would destroy venerable Lehman Brothers, and for that he was paid a \$45 million bonus in December 2007.

Across the entire financial industry, so far as we know, only one executive has had the simple decency to reject his golden parachute after his company failed: Robert Willumstad, CEO of AIG, who didn't create the problems at AIG but was asked to step aside anyway by the Feds. Willumstad was due \$22 million when he left, but he refused to accept it. We heartily recommend Mr. Willumstad to run the TARP program.

We wish we could argue that the greed and self-absorption of financial industry executives was a major cause of the financial crisis, but unfortunately we don't quite believe it. What we do believe is that the compensation follies complicated and prolonged the crisis in two ways. First, at the margin the compensation practices in the industry represented a misallocation of capital, i.e., away from improving products, services, risk controls, etc. and into the pockets of executives. Had the industry invested this capital more efficiently,

it might have foreseen and thus avoided some of the more devastating problems it now faces.

More important, the greed of the financial executives so revolted the American public that policymakers' hands have been tied to some extent in dealing with the crisis. The TARP program was initially rejected by the House of Representatives precisely because enraged constituents opposed it in overwhelming numbers. When industry figures were summoned to appear before Congressional committees, we were treated to the spectacle of demonstrators holding up signs reading, "Shame," "Cap Greed," and "Jail not Bail." Thus, as Treasury, the Federal Reserve and others try to deal with the crisis they have to be constantly aware that strategies that even appear to be bailing out greedy industry executives are off the table – especially during an election year.

Conflicts upon conflicts

We have elsewhere²⁷ detailed the conflicts of interest that permeate the financial industry, with an emphasis on the damage done to investors by these conflicts. But we might also speculate about the damage done to the ethical compass of people who have worked in conflicted institutions for their entire careers. If you know you are selling inferior in-house products to your customers, and if you observe that, time after time, you are richly rewarded for doing so, might you not, at the end of the day, forget that what you are doing is wrong?

All the top executives at America's financial firms have spent their entire lives living in a closed architecture world. Is it any special wonder that they care so little about their clients? Just to pick one obvious example, Citigroup recently removed Sally Krawcheck, the most prominent woman on Wall Street and the head of global wealth management at Citi. One prominent irritant between Krawcheck and Citi CEO Vikram Pandit was that Krawcheck (a former independent analyst at Bernstein) wanted the financial advisors at Smith Barney to operate in an open architecture manner, offering the best possible products to their customers. Pandit, you will not be surprised to learn, wanted the advisors to stuff customer portfolios full of Citi products, good, bad or indifferent.²⁸

Where Do We Go from Here?

No one can doubt that excesses like too much leverage, poor risk controls and a firm belief that housing prices could grow to the sky were the immediate cause of the financial crisis. But unless we are to believe in mass hypnosis – or perhaps that simply walking down Wall Street caused people to inhale stupid germs – the real question is why an entire industry collapsed at once, virtually every firm destroyed or badly crippled, the very face of the American financial sector changed unrecognizably in just a few months.

Our suggestion in this paper is that the common root cause of such destructive activity was the collapse of ethical behavior across the financial industry, and in particular the disappearance of any sense of fiduciary responsibility to the industry's customers.

Given the execrable conduct of the industry and its executives, one solution to the problem might be to tear the industry down and rebuild it according to very different principles and with very different people at the top. Few would put forth such a radical idea, of course. But we don't have to – it's happening before our eyes. Almost as though an avenging Old Testament God had stormed down to wreak havoc on the unjust, the worst offenders in the industry – James Cayne/Bear Stearns, Dick Fuld/Lehman, Tony Mozzilo/Countrywide – have been struck down, their firms gone from the face of the earth. And vengeance has been wreaked on others in the industry as well, from Goldman and Morgan Stanley to WaMu, AIG and Wachovia. Almost no one stood up for these firms and their now-beleaguered executives, because almost no one saw them as innocent victims of a financial crisis not of their making. Everyone saw the firms and their top people for what they were: greedy, hopelessly compromised, and getting pretty much what they richly deserved. To the extent anyone advocated a bailout, it was solely to protect innocent bystanders, to minimize the externalities.

But of course there were many innocent victims of the crisis, and there will be more: hardworking employees who contributed nothing to the demise of their firms, but who lost their life savings and have dim prospects for similar employment elsewhere; innocent investors who had the simple misfortune to believe the CEOs and CFOs who assured them that recovery was just around the corner; homeowners who swallowed the industry's insistence that they could afford the houses they were buying; and all the rest of us, mired in a deep Bear Market and looking forward anxiously to the coming recession.

Fixing the industry

No one knows whether the crisis management – an apparently endless game of Whack A Mole – carried out by PB&Co. will calm the markets and keep the economy from spinning out of control. But one thing we do know is that it won't address the core problems we've highlighted in this paper. You don't convert rogue enterprises into model corporate citizens by merging them into each other or by converting them into bank holding companies.

Instead, we modestly propose the following reforms:

- 1. The financial industry needs to adopt a laser-like focus on its customers and their welfare, in any event placing client interests far above the compensation interests of its executives.*

2. The industry needs to eliminate its infamous conflicts of interest, and to avoid even the appearance of conflicts.

3. Finally, the industry needs to demand ethical behavior across the board from its executives and employees, even if it is sometimes inconsistent with short-term profits, and this behavior needs to be both exemplified and enforced by top executives.

Anyone who has watched developments in the financial industry over the past five years would likely find these suggestions to be Pollyannaish in the extreme. And no doubt top executives in the industry will be horrified. But in every other industry these behaviors are routine, ingrained in employees from their earliest years and demanded by top executives and boards of directors. Emphasis on serving the customer is and has been for many years a mantra in most industry sectors. Ideas like Six Sigma, TQM, kaizen, quality circles, and the Toyota Production System are designed to help companies deliver the best possible products and services to their customers – an idea apparently unknown in the financial industry. As for conflicts of interest, they have been ruthlessly rooted out of most industries, including even the nonprofit world and the political world. But conflicts are mainly what the financial industry is all about: “No conflict, no interest.”

But we remember back in 1987 when Paul O’Neill, later to be Secretary of the Treasury, became CEO of Alcoa. Alcoa was then a sinking, Rust-Belt aluminum producer, its stock price long mired in the single digits.²⁹ If O’Neill had spent his career in the financial industry it’s not hard to guess what he would have done: cut costs, cut customer service, demand longer hours from his employees. This would have raised quarterly earnings briefly, O’Neill would have cashed out, and when Alcoa sank even further into the muck he would have glided off into the sunset supported by his bright golden parachute.

But not being from the financial industry, none of this occurred to O’Neill. Instead, he focused his major attention on – *worker safety*. At the time, Alcoa had one of the worst safety records in its or any other industry, and – guess what? – employees reciprocated by demonstrating a like concern for the firm and its customers. O’Neill demonstrated something else: that he cared about employees and their safety. Even low-ranking employees were given the power to stop production if they saw a safety issue. And the employees responded in kind, converting this sleepy also-ran into one of the most efficient, safe, and quality-conscious firms in the world. Profits soared, as did Alcoa’s stock and the firm’s reputation. Sure, O’Neill made a lot of money as Alcoa’s CEO, but he earned it and he is as revered today among Alcoa employees as he was way back then. Is anyone on Wall Street listening?

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¹ We don't mean "fiduciary responsibility" in the legal sense, but in the simple, straightforward sense of placing the client's welfare first, of earning the customer's trust.

² As banks make loans the ratio of assets (loans) to equity rises. Since regulators limit the amount of leverage banks can operate with (unlike investment banks), once a bank has made loans equal to (roughly) ten times its equity base, it can't make more loans without increasing its equity. But if the bank sells the loans it makes, those loans go off the balance sheet and the bank has additional lending capacity.

³ See "How Rating Firms' Calls Fueled Subprime Mess," Aaron Lucchetti and Serena Ng, Wall Street Journal, August 15, 2007, p. A1.

⁴ Kent Conrad and Christopher Dodd.

⁵ Alphonso Jackson and Donna Shalala.

⁶ James Johnson and Franklin Raines.

⁷ Most prominently, Richard Aldrich, a California judge then hearing a lawsuit against Countrywide. Guess who won the case?

⁸ Paul Begala, Henry Cisneros, CEOs William Esprey of Sprint and Bruce Karatz of KB Home, former UN Ambassador Richard Holbrooke, Congressional staff lawyer Clinton Jones III, Postmaster General John Potter, etc. See "Angelo's Many 'Friends,'" Condé Nast Portfolio, August 2008, p. 82.

⁹ But of course this happened to clients, not to folks in the financial industry. Federal prosecutors have charged David Shulman – the man who ran the UBS ARS business – with insider trading because he sold his own ARS before the market collapsed. The prosecutors also allege that UBS, knowing the market for ARS was unstable, decided to unload its own inventory of ARS onto its clients. See Amir Afrati, "US Auction-Rate Investigation Picks Up Steam," Wall Street Journal, October 2, 2008, p. A6.

¹⁰ The missions, charters and regulatory structure of Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) are essentially identical.

¹¹ "GS" (it stands for General Schedule) is the pay scale utilized by white collar workers in the civil service. The GS is separated into fifteen grades (GS-1 to GS-15) and each grade is separated into ten steps. A GS-13 would be upper middle management.

¹² Long-time CEO of Fannie Mae, ousted in 2005 because of an accounting fraud. OFHEO published a 211-page summary of its investigation into Raines, citing a litany of sins including manipulating FNMA's earnings, giving and receiving unjust bonuses, etc. In 2008 Raines settled by paying \$25 million.

¹³ Former CEO of Freddie Mac, ousted in 2003 also because of an accounting scandal. Brendsel paid \$13 million in penalties to OFHEO.

¹⁴ Former CEO of Fannie Mae, Mudd was paid nearly \$40 million in four years. He was fired in 2008 shortly after trying to place the blame for his failures on his Chief Financial Officer, Chief Risk Officer and Chief Business Officer.

¹⁵ Former CEO of Freddie Mac, fired in 2008, Syron was paid \$23 million in just the past two years.

¹⁶ See, generally, “It’s Time to Feast on Crow,” Jeffrey Goldfarb and Richard Bealees, *Wall Street Journal*, July 21, 2008, p. C8. Regarding Lehman, see “Lehman’s Assurances Ring Hollow,” Floyd Norris, *New York Times*, September 12, 2008, p. C1, and “The Two Faces of Lehman’s Fall: Private Talks of Raising Capital Belied the Firm’s Public Optimism,” *Wall Street Journal*, October 6, 2008, p. 1.

¹⁷ As we have pointed out elsewhere, rather than trying to pop the housing bubble or rein in predatory lending activity, Bernanke said, in late 2006, “US housing prices merely reflect a strong US economy.” In March of 2007, Treasury Secretary Paulson stated, “The economy is as strong as I have seen it at any time in my 32 year business career.”

¹⁸ Far *too* hasty. Notwithstanding the New York Fed’s terror, it was clear mere hours into the LTCM bailout that no bailout had been necessary and that there had never existed a threat to the global financial system. As soon as Wall Street had a look at LTCM’s trades, it realized that it was happy to step into the hedge fund’s shoes – a firm with a strong balance sheet was certain to make money on these trades, which were mainly good ones. LTCM’s problem wasn’t that it made bad trades but that it didn’t have enough capital to wait for spreads to narrow. Worse, certain firms – we won’t mention names – reportedly front-ran LTCM’s book after being given a Fed-approved look behind the curtain.

¹⁹ The failure to borrow a shorted stock by the settlement date.

²⁰ Commission rates for small investors actually went up, but commissions for the major traders went down by more than half. Eventually discount brokerage firms arose to offer lower commissions to smaller investors as well.

²¹ “Eye on the Market,” Michael Cimbalest, JP Morgan Chase, 9/10/08.

²² A typical bank, regulated by the Federal Reserve and Comptroller of the Currency, is leveraged at about 10-to-1.

²³ The net capital rule, which would have limited the investment banks to maximum leverage of 12-to-1, was abandoned in 2005.

²⁴ “Eye on the Market,” *op cit.*, note 20.

²⁵ Even the best-parachuted CEOs outside the financial sector would envy Alan Fishman, whose golden parachute at WaMu entitled him to \$19 million for serving as CEO *for nineteen days* at the date WaMu failed. JP Morgan Chase, which acquired the assets of the failed bank, has refused to pay about \$12 million of this.

²⁶ James Grant, “Why No Outrage?,” *Wall Street Journal*, July 19-20, 2008, p. W1.

²⁷ Greycourt White Paper No. 24 – “A Modest Proposal: Let’s End Conflicts of Interest in the Wealth Advisory Business,” (February 2003).

²⁸ “A High-Ranking Woman Is Out at Citi,” Eric Dash and Geraldine Fabrikant, *New York Times*, September 23, 2008, p. C7.

²⁹ Adjusted for stock dividends and splits. Under O’Neill, Alcoa’s stock price peaked at about \$35/share.