

A moral crisis

March 1, 2009

Much has been written about the economic and political causes of the crisis, but does the crisis have an ethical component?

The dimensions of the current economic and financial crisis have placed it at the center of today's political, scientific and media agenda. Many analyses have been carried out as to the causes, repercussions and how it might evolve.

However, many of these analyses have neglected the ethical factor, or if they have addressed it, they have done so in a superficial way.

This is the opinion of IESE Prof. Antonio Argandoña, who, in his article, "The Financial Crisis: The Search for Ethical Criteria," explains from an ethical standpoint why we find ourselves in this situation.

Many have pointed to greed on the part of bankers, a proliferation of fraud cases, the creation of exorbitant incentives and imprudent behavior as causes of the crisis. But are such explanations adequate?

Greed is nothing new

For those who see greed at the culprit, Argandoña feels that may be too simplistic an answer. Greed has always existed, and for this reason, mechanisms to control it have been designed, in the form of laws, in order to keep it from leading to fraud and corruption at an alarming level.

What happened over the past few years is that certain conditions emerged and conspired -

low interest rates, an abundance of liquidity, financial innovations - which allowed the profits reaped from this kind of behavior to be higher. Secondly, society itself helped to "induce greed" by rewarding those who have achieved success through greedy conduct.

The biggest failure, says Argandoña, are the control mechanisms. This failure created a perfect breeding ground for reaping excessive profit through risky operations and fraudulent behavior.

In the United States, for instance, one sees greed in such practices as paying mortgage brokers by the volume of loans they granted rather than their solvency; or in the risk that financial entities took on, thanks to explicit or implicit guarantees from the government.

But failures in the system of regulation and control are ultimately what have allowed us to reach the situation of crisis in which we now find ourselves.

High pay and fraud not themselves causes

Apart from greed, too much emphasis has been placed on sky-high compensation packages paid to executives, and on specific cases of fraud. Argandoña argues that, rather than being causes, these factors should instead be seen as effects of a specific context.

High salaries paid to executives and financial analysts can be explained by the fact that money always flows to whatever is in fashion. This leads to an increase in prices, which the forces involved try to take maximum advantage of. But the size of these remuneration packages alone fails to explain the volume of losses suffered by banks.

Fraud cases such as the one involving Bernard Madoff do not help to explain the crisis, either. The temptation to commit fraud has always been there, and regulators and judges exist in order to prevent it.

The lack of transparency is another feature of many kinds of conduct that triggered the crisis. The murkiness of some transactions, and the hiding or falsifying of information, make one believe that the leaders of some institutions were aware that they were engaging in immoral activities. In some cases, executives showed a lack of fortitude, while others acted with conceit and arrogance, thinking they knew more than anybody else, that they did not have to yield to supervision by others, or that they were above the law and moral norms.

Argandoña also detects a lack of prudence on the part of bankers and business leaders, an attitude that was favored by conditions in recent years of low interest rates, an abundance of

liquidity and moderate, stable inflation. Such behavior gave rise to a mob-like mentality that translated into a quest for immediate profits and the dumping of projects or investments which, while not yielding gains right away, might have ensured companies a prosperous future.

Might ethics have averted the crisis?

These recent years have seen shoddy government practices, which in many cases stemmed from incompetence on the part of decision makers. The bottom line is that optimal management of any company must evaluate each and every decision from an ethical standpoint.

But would ethical management have been enough to avoid the crisis? Perhaps not. A well-run company is not necessarily one with guaranteed continuity, because it can commit errors of calculation or in its expectations. If ethics cannot ensure the success of a business, it cannot do so for an entire economic system, either.

However, ethics could have eased the consequences of the crisis in the following ways:

- Averting the collapse of some institutions, or making it less likely.
- Contributing to the creation of a different climate in the business world.
- Doing a bit toward maintaining trust, the loss of which is one of the gravest consequences of the current crisis.

Recovering trust, and creating the right conditions allowing for the future development of a financial system based on trust, are two powerful reasons for developing an ethical culture in financial institutions. Such ethical measures, had they been applied across the board in financial institutions, would have made the crisis less likely and rendered its consequences less painful, says Argandoña.

Looking ahead, ethics must form part of the fundamentals of a financial system, which, at the very least, can skirt crises like the one we are now enduring and be a tool for growth, justice and prosperity.

www.iese.edu/insight