— ✤ PART ONE ✤ —

Background and Theoretical Framework

Cambridge University Press
978-1-107-01735-1 - Wall Street Values: Business Ethics and the Global Financial Crisis
Michael A. Santoro and Ronald J. Strauss
Excerpt
More information

— ✤ CHAPTER ONE ✤ —

A Financial, Governmental, and Moral Crisis

Introduction

On Monday, September 15, 2008, Lehman Brothers, a prominent investment bank that traces its roots to 1850, declared bankruptcy and thereupon triggered a global financial crisis. Literally overnight, borrowing came to a standstill, and widely held assets could not be converted into cash. The liquidity crunch immediately crippled banks owning substantial amounts of securities linked to subprime mortgages and spread very quickly to every sector of the global economy and all types of debt securities. Unable to sell even normally safe and highly liquid investments, on Tuesday, September 16, 2008, the Primary Reserve Fund, the oldest money market fund in the United States, in an action eerily reminiscent of Depression-era bank runs, shocked the financial community by freezing customer accounts and indefinitely halting withdrawals. Ordinary consumers were thus harshly reminded that there were no safe havens for their savings in this economic storm, adding another layer of uncertainty and instability to the financial markets. Within weeks of the Lehman bankruptcy, the resulting shock to the financial system inflicted severe and long-lasting damages on the economy, throwing tens of millions of people out of work and slowing economic growth. Half a decade later, the global economy still limps along in the aftermath of the financial crisis.

The financial crisis sprang from a precipitous decline in the value of mortgage-related securities. The bursting of the mortgage bubble completely wiped out Lehman's capital base. Other venerable Wall Street institutions including Merrill Lynch and Bear Stearns narrowly averted total collapse through hastily arranged mergers with Bank of America and JPMorgan Chase, respectively. Virtually every major financial institution had massive exposure to the mortgage market relative to its capital base, and even those banks not in danger of imminent collapse suffered staggering losses severely limiting their ability to engage in ordinary consumer lending activities and basic interbank transactions. Because of the financial sector's centrality to capital and credit markets, the U.S. Congress authorized a $700 billion government bailout to prevent further failures and safeguard the financial system from total collapse.

The global financial crisis and the prolonged economic recession that ensued raise complex and vexing questions inextricably melding economics and morality. What are the economic and moral connections between Wall Street and the overall economy? How did we arrive at this point in history where our most powerful financial institutions and the putative engine room of capitalism thwart rather than promote our free markets, our prosperity, and even our social cohesion? What essential elements and systemic features of our financial system make it possible for a very few individuals to amass enormous personal wealth as they help plunge the rest of society into a deep and enduring economic recession, putting millions out of work? What can be done both within the financial community and by governments to repair the fractured relationship between Wall Street and Main Street? These are the economic, ethical, and public policy questions we address in this book.

Financing the Debtor Nation: A Brief Overview of the Origins of the Financial Crisis

The story of how Wall Street firms became "too big to fail" and had to be saved at considerable taxpayer expense has been much chronicled in once esoteric terminology that has become all too colloquial for ordinary citizens. The seeds of the crisis were being sown for years by overleveraged banks and pension funds from Mississippi to Dusseldorf that placed outsized and risky financial bets on the value of collateralized debt obligations (CDOs) packaged and sold by Wall Street firms and based on an unreliable stream of payments by overleveraged American homeowners holding subprime mortgages. CDOs are financial instruments created by Wall Street firms that divide debt instruments into slivers (tranches), each of which is entitled to a precisely defined slice of the future cash flows from the original pool of future payments. The most common debt instruments whose future cash flows were repackaged in this manner were mortgages – loans secured by real property owned by homeowners and investors. The classic CMO, or collateralized mortgage obligation, was created by pooling mortgages that were then repackaged into a wide variety of tranches, each with rights to precisely defined mortgage-backed cash flows. Consequently, each CMO slice had unique risk and return characteristics.

Ironically, the invention of CDOs was one of the most important and socially useful financial innovations of the late twentieth century. It allowed investors to precisely calibrate the mixture of risk and return they wished to assume when investing in debt-based securities. In this sense, CDOs represented an important advance in the efficiency of capital markets. CDOs also offered advantages to homeowners and borrowers by enabling substantial flows of capital into debt markets, thereby making it easier for consumers to access credit to help purchase everything from a car to a house. In 2004, for example, homeownership rates in the United States reached 69.4 percent. (It has since slipped down to 66 percent.) Of course, the flip side of this easy credit has been a spike in consumer debt and a high incidence of personal bankruptcy among overextended consumers – 1.5 million in 2010 alone. The fatal misstep inexorably leading to the financial crisis arose from the proliferation of CMOs based on subprime mortgages of borrowers with high credit risks based on debt payment history, income qualifications, or other actuarially based indicators. Further contributing to the magnitude of Wall Street's financial bet on subprime mortgages was the invention of synthetic CMOs or derivatives. Unlike the classic CMO constructed from real cash flows from real mortgages, derivatives used contracts to mimic the underlying economics of particular slices of actual pools of mortgages. Neither party to the derivative contract actually owned any interest in the underlying mortgages being referenced in the derivative contract. This methodological innovation unleashed exponential growth in the total mortgage-related debt market and dramatically increased systemic risk in the financial markets.

Catalyzing all this was a cavalcade of incompetence, corruption, and fecklessness. Rating agencies such as Standard & Poor's and Moody's assigned investment grades to subprime CMOs, thereby promoting the idea that financial alchemy devised by Wall Street wizards would enable investors to enjoy the high returns normally associated with risky investments with the security normally reserved for more modest financial returns; subprime loan originators such as Countrywide, Washington Mutual, and Ameriquest that cut corners on standards and documentation to feed the pipeline of mortgage-backed securities that Wall Street craved; mismanaged quasi-federal agencies such as Freddie Mac and Fannie Mae, which (utilizing below-market-rate capital made possible by an implicit government guarantee) purchased ever-increasing amounts of subprime mortgages from the originators, thus allowing them to make additional poorly documented and risky loans; monoline insurers such as AIG, which failed to understand the individual and aggregate of risk they were creating by guaranteeing so many transactions for diverse institutional players in the mortgage markets; and of course the lawyers and accountants who saw, heard, and spoke no evil and who blithely papered over the whole fiasco. It should probably also be said that partial blame must go to some consumers who irresponsibly took out mortgages for amounts they should have known they would not be able to repay, although, to be fair, there were many other consumers who were duped and defrauded by loan originators into taking out loans that were inappropriate for them or contained misleading terms.

Although we do consider these various other actors, our principal focus in this book is on Wall Street, the group of large and powerful financial institutions that orchestrated the financial crisis. We also devote considerable attention to how the government facilitated and exacerbated the financial crisis – first by promulgating regulatory loopholes allowing the market for CMOs and derivatives to grow exponentially and without public oversight, and then by falling asleep at the wheel and being caught completely off guard by the gathering storm. Moreover, as we shall describe in greater detail, the unintended consequences of government policies helped sever the connection between Wall Street profits and free markets that had served the economy well for more than a half-century.

The 99%: Occupy Wall Street and Public Anger over the Bailout

For ordinary citizens, the specter of a $700 billion publicly funded Wall Street bailout was infuriating. Adding insult to injury, many Wall Street executives walked away with huge compensation packages. Even executives in financial firms that declared bankruptcy enriched themselves with outsized cash bonuses as the global economy was thrown into turmoil, and tens of millions of workers around the world ended up out of work. In 2011, that anger spilled over into the streets as Occupy Wall Street protesters set up tents in Zuccotti Park, just steps from the epicenter of capitalism. The group decried economic inequality (hence the rallying cry "we are the 99%") and corporate influence over the government, but its principal eponymous target was Wall Street and the financial services industry. Some have questioned the efficacy and propriety of its direct action tactics. Nonetheless, Occupy Wall Street was emblematic of a broad public disaffection with the financial industry. According to the National Opinion Research Council, from 2006 to