

# Ethical Dilemmas in the Financial Industry

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*This case explores the recent global financial meltdown as an example of unethical behavior among U.S. corporations. The case notes that such corporate scandals are much more common and cyclical than the general public might believe. It challenges the commonly held notion that a few individuals are responsible for the misconduct. This case, by contrast, offers a more complicated interpretation, both of financial crises and of organizational ethics in general. While the home mortgage ideology and related systems did provide opportunities for exploitation by excessively greedy individuals, it also created impossible situations for honest actors who were struggling to meet the contradictory needs of multiple groups of stakeholders.*

If a reward system is so designed that it is irrational to be moral, this does not necessarily mean that immorality will result. But, is this not asking for trouble?

—Kerr (1975, p. 770)

**S**ince 1900, the United States has repeatedly experienced a cycle that begins with the development of an investment “bubble” in the financial industry, which eventually explodes. It is quickly followed by a government (taxpayer) bailout of the organizations whose members took on far too much risk in pursuit of massive individual rewards and organizational profits.<sup>1</sup> Almost every generation has lived through one of these cycles, but

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<sup>1</sup> A “bubble” is a precipitous rise in the value of an asset that cannot be explained by fundamental economic principles. Prices paid for the asset rapidly increase, based almost wholly on the belief that they will continue to increase. Cautionary responses are dismissed through a rhetoric claiming that the economy has entered a “new era of growth” in which the “fundamentals of investing” have changed (Posner, 2010).

today's "twentysomethings" have experienced two—the savings and loan (S&L) crisis of the late 1980s and the financial industry meltdown of 2007 and beyond. Young adults, who are notoriously uninterested in economics and only sporadically interested in politics, now have trillions of reasons to be interested in these seemingly esoteric topics. This is because *they* will be paying for the current crisis and bailouts for decades to come in increased taxes, limited economic growth, frustrated career aspirations, and reduced retirement income. And that picture is becoming even bleaker. The modest regulatory reforms enacted after the 2008 crash (usually called the Dodd–Frank Act) did very little to change the underlying factors that created it (Blake, 2010; Cohan, 2010). Banks that were "too big to fail" are even larger now; the campaign contributions and industry lobbying efforts that undercut meaningful regulatory reform have grown astronomically, and the processes that create cycles of economic bubbles, crashes, and bailouts still are in place (Cohan, 2010; Johnson, 2010; Morgenson, 2011b; Posner, 2010; Stiglitz, 2010). Regulators charged with implementing the Dodd–Frank act are doing so in ways that exacerbate those problems (Davidoff & Henning, 2010; Johnson, 2011; Krugman, 2011; Puzanghera, 2011), and leaders of the Congress elected in 2010 have vowed to roll back regulatory reforms and cut the budgets of regulatory agencies (Fram, 2011; *New York Times* Editorial Board, 2011). Of course, politicians now claim that they will never again bail out financial institutions, but they made the same claims after the bailouts of 1907 (J.P. Morgan), 1974 (Franklin National Bank), 1984 (Continental Illinois Bank and Trust), and the S&L crisis.

The easy response to these events is to condemn all of the individuals who were involved—that is, to criticize the ethics of homeowners who took on loans they eventually could not afford, financial officers who persuaded them to do so, Wall Street operatives who found innovative ways to obscure the level of financial risk contained in the products they were selling, lobbyists who persuaded Congress to weaken regulations and hamstring regulators, and politically appointed regulators who actively suppressed dissent by some of their employees and ignored warnings from others (see Fox, 2010; Jackall, 2009; Posner, 2010). Of course, this response is easy to understand. In highly individualistic cultures such as the United States, "morality" is treated as an attribute of each person, and "ethics" is viewed as a process through which *individuals* draw upon their *own* moral codes to make decisions about how to act in concrete life situations. But, as noted in the introduction to this book, this individualistic, "foundational" perspective is problematic in a number of ways.

First of all, it ignores the need to carefully and realistically examine the contexts within which people make ethical choices—to "walk a mile in their shoes" as the old adage suggests. All cultures strive to teach their members the difference between right and wrong. They also teach their members how to interpret the situations they face and how to act ethically in response to them. But many situations are ethically ambiguous, and others reward people for acting unethically and/or punish them for acting ethically. Individuals *are* responsible for the ethicality of their choices, but they make those choices within situations that were constructed over long periods of time through choices made by other people. Expecting individuals to make ethical choices within unethical systems and situations is unrealistic and unfair. In addition, individualizing organizational ethics shifts attention away from situational factors, making systemic reform less likely, and ensures another round of bubbles and bailouts.

The second ethical dilemma in “foundational” views involves the disparate interests of multiple stakeholders. Because stakeholder interests often conflict with one another, making an *ethical* choice usually requires a decision maker to privilege the interests of some stakeholders and violate the interests of others—for example, a choice that treats workers in an ethical manner may unfairly penalize stockholders and vice versa. From a purely legal perspective, this is not a problem—a manager’s *legal* responsibility is to maximize the income of the organization’s owners (individuals, or stockholders if the organization is a publicly owned corporation) through maximizing the firm’s profits. Privileging any other stakeholders’ interests violates this fiduciary responsibility and thus is “unethical” from a purely legal perspective (Friedman, 1970). Moreover, engaging in socially responsible activities (that is, privileging the interests of other stakeholders) costs money so it puts the firm at a disadvantage compared to competitors that only seek to maximize profits. Doing so threatens the survival of the firm, which punishes its owners/stockholders, employees, and the communities within which the firm operates.<sup>2</sup> Even if the firm survives, applying “multiple stakeholder” models of organizational ethics can lead decision makers to violate their employment contracts and impose their own ethical values on the firms they have been hired to manage. Both of these dilemmas are illustrated powerfully by recent crises in the financial industry.

## CONSTRUCTING THE ETHICAL SYSTEM FOR HOMEOWNERSHIP

Recent financial industry crises were grounded in an assumption that has been taken-for-granted in the United States for more than a half century—that homeownership is virtuous. The concept may have been part of the “American dream” from the country’s beginnings, although early immigrants wanted to own property more as a *means* of escaping the abusive landlords and debtors’ prisons of their countries of origins than as an *end* in itself (Cawelti, 1974). Owning *land* also was a *means* of gaining financial independence through farming and ranching. But homeownership as a desired *end* in itself was an alien concept. In fact, when historian James Trulow coined the phrase “the American Dream” in 1931, it did not include homeownership at all, much less depict it as *the* key component. But by the early 1900s, politicians of all stripes, as well as spokespersons for the home construction and sales industry, were elevating the concept to a core cultural value—an *end* in itself—and creating structures to encourage it.

Over time, the rhetoric of homeownership has been remarkably persuasive. Almost all U.S. residents now see it as *the* most important element of the American dream, an investment that will enhance the quality of their lives and the lives of their children. However, statistical correlations between homeownership and its purported positive effects—increased citizen involvement in politics and civic organizations, better educational systems, lower rates of crime, fewer school dropouts, and reduced teen pregnancy—are weak, and there is even less evidence supporting the inference that homeownership causes those outcomes. Family auto ownership is more strongly related to dropout rates than homeownership,

<sup>2</sup>The rhetorical appeals underlying this position are analyzed superbly by James Arnt Aune (2007) and Cheney, Roper, and May (2007).

and all of these outcomes are correlated more strongly with time spent in a community than with homeownership *per se*. Furthermore, both the outcomes and homeownership are better predicted by other factors (having a stable family life and average neighborhood income) than by one another (Kiviat, 2010).

Furthermore, the mythology ignores a number of disadvantages to homeownership, the most important of which is the “illiquidity” of housing. It is hard to turn a house into cash, especially during recessions when people most need to be mobile in order to relocate to areas with better job prospects. As a result, the areas with the highest levels of homeownership also tend to have the highest levels of unemployment—during recessions the “stability of homeownership” is transformed into “being trapped in a house you cannot sell” (van Praet, 2011). But, in spite of all these data, Americans *believe* the mythology of homeownership and do so without questioning it. Cultural assumptions are sustained by perceptions and rhetoric, not by data and statistical analysis.

The homeownership mythology also has led to the creation of a number of supportive systems. For individuals, the most important of these are subsidies and deductions that are built into the federal tax code, something that almost half of homeowners cite as a primary reason for buying a home instead of renting (Hiber & Turner, 2010). There is no question about the size of these incentives—in 2010, the federal government lost more than \$100 billion in revenue to them, more than double the loss in 1995, and it is estimated that the total loss from 2010 through 2013 will exceed \$500 billion (Harrop, 2011). But to get tax advantages, taxpayers must itemize their deductions, an option that largely benefits wealthier households. In 2009, the 2.8 million home-owning families with incomes above \$250,000 (the top 2% or so) saved \$15 billion a year in federal income taxes (about \$15 a day each), while the 19 million families making \$40,000 to \$75,000 (middle income) saved only \$10 billion (about \$1.50 a day) (Peterba & Sanai, 2010). In addition, being able to deduct interest paid to purchase *second* homes exclusively benefits wealthier taxpayers (this deduction alone was worth \$800 million in 2010). Being able to deduct property taxes increases these effects.<sup>3</sup> Of course, a tax and subsidy system that primarily rewards wealthy taxpayers but is justified in terms of the rhetoric of homeownership *for all* raises some important ethical questions.

For financial institutions, the homeownership system includes a series of government-sponsored and funded incentives and protections. Savers will not deposit their funds in financial institutions unless they believe that it is both safe and profitable to do so. Similarly, the “dream” of homeownership will be within the reach of nonwealthy families only if financial institutions can be persuaded to offer home mortgages on terms that make them affordable. In order to persuade savers that banks were safe after the economic crash of 1929, the Roosevelt administration created deposit insurance programs (the Federal Deposit Insurance Corporation [FDIC] for banks, the Federal Savings and Loan Insurance Corporation [FSLIC] for savings and loans, and so on). Funded by a combination of levies on financial firms and tax monies, there were (and still are) two rationales for these programs.

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<sup>3</sup>The system also has a number of indirect costs, the most important of which is encouraging suburbanization that forces taxpayers to pay for infrastructure—highways, sewer lines, utilities, and so on—that would not be needed in an urban, more rent-oriented society.

The first is practical—persuading people to deposit their savings in a financial institution allows them to loan money to entrepreneurs who want to start businesses, small business owners who want to expand their operations, and/or families who want to purchase homes. Since society as a whole benefits, the risks taken by depositors should be spread over the entire society—that is, they should be “socialized.”

The second rationale for deposit insurance is ethical. Depositors almost never have any influence over the decisions that create financial crises. Financial institutions are “limited-liability” corporations, which means that if a bank or S&L fails, the people who manage them and the stockholders who own them cannot lose more money than they have invested in the organization. For managers, this usually means that making bad decisions *might* get them fired, but they will not lose their assets. However, the *gains* that decision makers receive if things go well are not socialized—they are left in the private hands of managers and owners (usually stockholders). This *combination* of socialized risks/losses and privatized gains creates “moral hazards,” situations in which it is economically rational for managers to take excessive risks (and owners to allow or encourage them to do so). They control large sums of other people’s money, will benefit handsomely if their risky actions succeed, and will break even if they fail. If decision makers also believe that government (taxpayers) will bail them out when they make bad choices, the hazard is increased. So it would be unethical to put depositors’ life savings at risk when the people who decide how to manage that money do not have *their own* assets at risk. Of course, while deposit insurance programs protect depositors from unwise managerial decisions, they do not protect taxpayers. To do that, governments must regulate financial institutions very tightly.

The goal of widespread homeownership also relies on persuading financial institutions to offer mortgages at a low enough interest rate and extend repayment schedules over a long enough period of time to make monthly payments affordable and predictable. The kind of mortgage that became the U.S. standard—one that has a 30-year term and a fixed interest rate—achieves this goal but creates two kinds of risk for lenders, *credit risk* and *interest rate risk*. Credit risk involves the possibility that borrowers may default on a mortgage. This is especially likely during recessions when people lose their jobs or move from full-time to part-time work. During recessions, the value of the homes that are used as collateral for mortgages also tend to fall, leaving financial institutions holding property that may be worth less than the balance left on the mortgage. In order to encourage lenders to offer these long-term mortgages, the Roosevelt administration created the Federal Housing Administration (FHA). It guaranteed that the government would pay the balance owed by borrowers who defaulted on their mortgages, as long as all parties had met a number of requirements when the mortgage loan was created. By shifting credit risk from lenders to the federal government (taxpayers), they would be able to offer home loans on terms that nonwealthy Americans could afford.

Long-term mortgages also involve interest rate risk for lenders. This kind of risk is a bit more difficult to explain. In order to attract deposits, financial institutions that offer mortgages must be safe *and* must offer a high enough interest rate on savings accounts. Since economic conditions (and thus short-term interest rates) fluctuate frequently, tying up funds in a 30-year mortgage at a fixed interest rate is incredibly risky for lenders. They cannot adjust the interest they charge on long-term mortgages to reflect the changing

interest rates paid on savings deposits. So if a society really does value homeownership for as many people as possible it must find a way to help lenders manage interest rate risk. This is why the federal government created Fannie Mae in 1939.<sup>4</sup> It purchases federally insured mortgages from the FHA, thereby encouraging lenders to offer affordable mortgages to more people. In order to protect the government's (taxpayers') investment, Congress adopted a series of very strict regulations, the most important of which were included in what was called the Glass-Steagall Act, and created the Federal Reserve System to regulate the financial industry. The Fed quickly enacted two important rules for mortgage lenders. One prohibited them from investing in risky venues such as the stock market. Another (called Regulation Q) limited the interest rates paid on savings accounts, but allowed S&Ls, which were the primary source of home mortgages, to pay a little more interest (usually 1/4% to 1/2%) than other institutions.<sup>5</sup> When considered *as a group*, these measures encouraged savers to place their money in mortgage-granting institutions (by socializing risk and giving savings accounts an interest rate advantage), protected those institutions from credit risk and interest rate risk, and offset moral hazards through tight regulation. But for the system to work each and every component had to be maintained—changing or weakening one would undermine the entire system.

## BUBBLES AND BAILOUTS, FIRST VERSE

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The policies enacted during the 1930s were remarkably successful in making homeownership possible for millions of middle-income Americans. In addition, for half a century the regulations included in the Glass-Steagall Act protected taxpayers from the risks that were included in the homeownership system. But during the early 1980s, the situation changed quickly and radically. In order to deal with the economic crisis of the late 1970s, the Carter administration created 6-month savings certificates that paid higher interest rates than those allowed on regular savings accounts. It also allowed stock brokerage firms and insurance companies to offer money market mutual funds that offered savers even higher interest rates. Even though money market funds were not federally insured (something that many depositors did not realize and many money market salespersons did not make clear to them), people rapidly moved their funds out of traditional savings accounts. Suddenly, S&Ls were saddled with commitments to millions of dollars in long-term mortgages at low, fixed interest rates but could not pay enough interest to attract or keep savings account deposits. The balanced regulatory system that had been created during the 1930s was being dismantled, and interest rate risk skyrocketed.

After the election of Ronald Reagan in 1980, life rapidly became even more complicated for mortgage lenders. In order to fight inflation, Treasury Secretary Paul Volcker increased interest rates, driving the returns on 6-month certificates of deposit to more than 15%. To make matters even worse, the new administration decided to further deregulate the financial

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<sup>4</sup>Freddie Mac was created later.

<sup>5</sup>This combination protected S&Ls against interest rate risk, but the industry continued to lobby for the right to offer adjustable rate mortgages (ARMs) whose interest rate changed along with economic conditions. Because ARMs contradicted the socially legitimized goal of encouraging homeownership by as many people as possible, Congress repeatedly rejected the proposals.

services industry. In 1980 and 1982, Congress eliminated Regulation Q, and the people who were regulating the industry allowed banks and S&Ls to *both* invest in much riskier products than before *and* to write mortgages for people who would not have qualified under previous rules.<sup>6</sup> Managers of S&Ls, most of whom had no training in how to deal with a volatile, highly competitive market, were suddenly faced with the *combination* of sky-high interest rates, deregulation, and interest rate competition, precisely the combination that the Glass-Steagall Act had been designed to prevent. Their cash reserves continued to plummet. In a search for higher returns, many S&L managers abandoned mortgage lending altogether and engaged in land speculation and risky commercial ventures, primarily in California, which was in the midst of an economic boom supported by a real estate bubble, and in Texas, whose economy was buoyed by high oil prices. In many cases, the riskier investments did not pay off, and thousands of honestly managed S&Ls teetered on the edge of bankruptcy. In addition, the resulting chaos was an invitation for unscrupulous figures to enter the industry and for accountants to engage in questionable auditing practices.<sup>7</sup>

Then, in the mid-1980s the California housing bubble burst and oil prices plummeted, with a devastating effect on the Texas economy. By 1989, half of all U.S. S&Ls were bankrupt. People who still had funds in traditional savings accounts were protected by the FSLIC, but it soon ran out of funds and had to be shored up by a \$20 billion infusion from Congress. The industry eventually received the largest taxpayer bailout in U.S. history, but only after a great deal of political theater.<sup>8</sup> The moral hazards that Glass-Steagall had been carefully crafted to avoid had come to pass with a vengeance, and the S&L bailout solidified the perception that managers of financial institutions would be able to shift the costs of risky and/or unethical behavior to taxpayers.

## BUBBLES AND BAILOUTS, SECOND VERSE

Within months, the lessons of the S&L crisis and bailout seemed to be forgotten. A new rhetoric emerged, one asserting that the debacle had resulted from the excesses of a few “bad apple” managers and not because of anything that was wrong with the changes that had been made in the regulatory system.<sup>9</sup> Attention quickly shifted to Iraq’s invasion of Kuwait and Operation Desert Storm. By the mid-1990s, the fervor for deregulation had

<sup>6</sup>The most important steps were the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St. Germain Depository Institutions Act of 1982. Individual states also began to compete with one another to attract financial corporations by weakening their regulations.

<sup>7</sup>Criminal misconduct and insider abuse was a “principal” or “significant contributing” factor in more than 20% of S&L bankruptcies (see the 1987 study by the House Subcommittee on Commerce, Consumer, and Monetary Affairs, summarized in Strunk & Case, 1988).

<sup>8</sup>Five senators were accused of interfering with regulators who were investigating fraudulent activity. Only one, Alan Cranston, was formally reprimanded by the Senate Ethics Committee, and two, who were found to have exercised bad judgment (John Glenn and John McCain) ran for reelection and won. President George H. W. Bush’s son Neil was fined \$50,000 for “multiple breaches of his fiduciary duties” and barred from running financial institutions. Bailout of this S&L cost the taxpayers \$1.3 billion, and a federal suit against Bush and other officers was settled out of court for \$26.5 million. Congress and the Bush administration arranged to have the bailout excluded from the official federal budget so that it would not increase the official budget deficit, and the bankrupt S&Ls were sold at a fraction of their prebankruptcy value, often to the same managers whose excessive risk-taking had driven them into bankruptcy.

<sup>9</sup>For an analysis of “bad apples” rhetoric, see Cheney, Lair, Ritz, and Kendall (2010), Conrad (2004), and McMillan (2007).

returned, and financial industry lobbyists increasingly pressured Congress to eliminate what remained of the Glass-Steagall Act. They finally succeeded in 1999.<sup>10</sup> At the same time, employees of financial institutions developed innovative techniques that made it easier to disguise the level of risk that was involved in the products they sold. The most important involved *derivatives*, which are complex financial instruments whose value depends on the worth of other complex financial instruments that are then sold to other investors. Derivatives have a number of legitimate purposes. For example, they provide funding for new industries that do not have access to traditional loans. But they also can be used to shift risk to unsuspecting parties, obscure the actual value of investments, and generate massive profits for financial firms that far exceed their contribution to the economy (Posner, 2010). By 2004, the global derivatives market, which was almost nonexistent just a decade earlier, was worth more than \$70 trillion (Johnson & Kwak, 2010).<sup>11</sup> In addition, antiregulation interest groups persuaded politicians (most of whom needed very little persuasion) to further weaken accounting standards and government regulation of financial transactions (Johnson & Kwak, 2010).<sup>12</sup> All that was standing in the way of another financial meltdown was a period of sustained low interest rates and an investment bubble. Like the S&L crisis, the bubble came in real estate.

To explain the ethical situation involving the mortgage industry in the late “aughts” (2005–2009), we need to return to the mythology of the American dream. It legitimizes active government intervention in the mortgage market in order to make homeownership available to as many families as possible. In 1995 and 1997, the federal government took steps to make the dream accessible to low or moderate income families by encouraging lenders to approve loans for applicants who previously would have been deemed marginal. The primary mechanism for doing so was the ARM, which had long been advocated by the home mortgage industry (Cantrell, 2010). Strong economic growth and increasing home prices during the 1990s made it *seem* like borrowers’ incomes were likely to rise in the future, which would allow them to manage the increased payments they would encounter when the initial interest rates on their ARMs rose. Steadily increasing home values also made it *seem* that even if borrowers did default on their mortgages financial organizations would be able to repossess their homes and resell them at a profit. So offering what came to be called “subprime” mortgages *seemed* to be safe, in part because lenders started to believe their own rhetoric about a never-ending increase in home values (Posner, 2010). Deregulation of the industry *allowed* mortgage writers to create even more “innovative” (which meant risky) kinds of mortgages, which made even more people eligible. Bringing more people into the mortgage market stimulated the construction of new homes and drove up housing prices, which made it *seem* that home values would continue to increase.

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<sup>10</sup> The bill that did so was called the Financial Modernization Act but is more commonly known as the Gramm-Leach-Bliley Act.

<sup>11</sup> Derivatives are like packages of meat. While all of the meat in a package may be lean and free of bones and gristle, an unscrupulous butcher may have put very nice cuts on the top of a pile of low-quality ones and then sealed them up in the same package. Unless a customer looks very closely, which may be impossible if the packages already have been sealed and/or they are very large, she or he can wind up with a very bad investment.

<sup>12</sup> The legislation was called the Community Reinvestment Act. It also was motivated by evidence that some lenders were “redlining” minority mortgage applicants (refusing to loan them money even if they met standard financial criteria, particularly if they were trying to buy houses in traditionally white neighborhoods).



In addition, large mortgage lenders such as Countrywide Financial, Ownit Mortgage Solutions, and American Home Mortgage shifted away from using human underwriters to assess the creditworthiness of applicants to cheaper automated systems. This reduced the amount of time needed to process a loan application from about 1 week to 30 seconds but added risk to the system because automated systems cannot detect the unique combinations of risks that humans might have found. By 2007, approximately 40% of subprime loans were being accepted by automatic systems (Browning, 2007). Even after the 2007 and 2008 crises, major banks continued the practice (Krugman, 2011).

The growth of the mortgage industry meant that financial organizations were holding a very large amount of debt by historical standards. Some especially innovative employees took a cue from the derivatives market and realized that they could bundle mortgages together and sell stock using them as collateral. This would provide additional funds for their organizations to invest, garner massive bonuses for them, and shift much of the risk to the people who purchased the stocks. If all of the mortgages that were “securitized” in this way had been of high quality, it would not have created much of a problem. But some banks started packaging subprime mortgages with good ones. Since some of these packages were worth a billion dollars or more, a lot of subprime loans could be included in securities “packages” without anyone noticing. In theory, ratings agencies are supposed to protect buyers by labeling bundles as A + +, B +, etc., based on the level of risk that they contained, but for a number of reasons, they did not do an adequate job (Krugman, 2009). Bankers also suggested to insurance companies that they should create policies that guaranteed the value of these bundles. Since the insurance companies (the biggest one was AIG) thought the bundles were safe (in part because they had little incentive to examine them very closely) and knew that these insurance policies could be very, very profitable, they cooperated by creating what came to be called “credit default swaps.” By 2005, the number of loans that were bundled and sold as mortgage-backed securities was almost 27 times larger than the *total* value of *all* mortgages written 10 years earlier (Cantrell, 2010). Since the banks’ high-risk mortgages had been shifted to others, they could write even more subprime mortgages and take on even greater risks. If a mortgage applicant could not qualify for one type of “alternative” loan, other alternatives were created. Eventually, even applicants who had neither the savings needed for a down payment nor stable employment were routinely approved.

In addition, the federal government responded to the economic downturn after 9/11 by lowering interest rates across the board, further increasing the number of potential homeowners. As early as November 2002, Federal Reserve Chairman Alan Greenspan realized that these trends could not be sustained over the long term and told a private meeting of Fed officials that the housing boom could not continue indefinitely (Mishkin, 2008). But, Greenspan’s public comments painted a very different picture. In 2003, he declared that the 2001 to 2002 recession was over (even though it would be years before unemployment returned to prerecession levels), which encouraged the “irrational exuberance” that he had previously warned against. His repeated declarations that a major drop in home prices was “quite unlikely” fed the bubble further (Johnson & Kwak, 2010; Posner, 2010). In a form of self-fulfilling prophecy, easy credit and low interest rates supported both a boom in homebuilding and increasing housing prices, which made risky loans *seem* to be secure, and a housing bubble was born and nurtured.

However, economies move in cycles. When the U.S. economy began to slow after 2004, unemployment increased and the incomes of people who still had jobs plateaued or started to decline. With reduced demand, housing prices leveled off and in some areas began to fall. By early 2005, people who had taken out ARMs saw their payments increase, sometimes significantly, as their low initial teaser rates expired. Some lost their homes—70% more people faced foreclosure in 2005 than the year before. Housing developers who had raced to build homes with subprime borrowers in mind now had fewer customers, leaving tens of thousands of homes unsold, further reducing housing prices. By June 2008, the bubble had exploded—new home sales were 33% lower than a year earlier (Mishkin, 2008; “The Wrecking-Ball Response,” 2008). The declining market left many homeowners with property that was worth less than the amount they owed on their mortgages (they were “underwater” in loan speak), making it impossible for them to refinance their mortgages or sell homes they could no longer afford (Klein, 2008). Soon, the housing crisis spilled over to other parts of the economy, dragging down retail sales and making consumers less willing to spend on new cars and other items (Posner, 2010; Stiglitz, 2010). Financial organizations now were so large and so tightly interconnected that the failure of one would have ripple effects throughout the system. Since the largest firms had taken on the largest risks, the entire system was on the verge of collapse. The naysayers who had opposed deregulation and the destruction of the Glass-Steagall Act had been proven correct, and the Great Recession was born.

## SUMMARY

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The most popular response to both the S&L crisis and the 2007 through 2008 financial industry meltdown has been to condemn individuals and organizations for engaging in excessively risky behavior in order to make themselves rich at the expense of the rest of society. While this individualistic, good versus evil interpretation is consistent with U.S. culture, it lumps all of the people involved in the process into one of two homogeneous groups regardless of the specific situations they faced. In addition, it feeds the “bad apples” orientation that historically has absolved those who created risk-inducing systems of responsibility for them, in the process short-circuiting pressure to make meaningful changes to the system. Condemning the villains and calling it a day may feel good, but it does nothing to prevent the recurrence of investment bubble-crisis-bailout cycles. In this case study, we have offered a more complicated interpretation, both of financial crises and of organizational ethics in general. While the home mortgage ideology and related systems did provide opportunities for exploitation by excessively greedy individuals, it also created impossible situations for honest actors who were struggling to meet the contradictory needs of multiple groups of stakeholders.

In this summary, we offer an even broader perspective. These crises coincided with an era of fundamental change in the economies of the Western capitalist democracies. From the 14th century on, people have been defined by their “character,” by the ethical value that they placed on their own desires and their relationships with other people (Sennett, 1998). Character was expressed through loyalty, mutual commitment, and the pursuit of

long-term goals—delaying gratification for the sake of the future. But the “new economy” that started to emerge during the 1970s and became firmly entrenched after the fall of the Soviet Union in 1990 has severed links between people, their organizations, and the future. The resulting “flexible capitalism” demands nimble behavior, a focus on short-term goals, instantaneous adjustment, and independence from our organizations and our relationships. The stable foundations of our identities and our ethical systems have disappeared, creating a new kind of uncertainty that is “woven into the everyday practices of a vigorous capitalism” (Sennett, 1998, p. 31). Some of us have responded with fatalism (see Giddens, 1991); others have learned to maneuver in the moment, doing whatever is necessary to reduce the risks and uncertainties we face. Suddenly, neither morality nor security depends on honesty, long-term relationships, or a work ethic. Instead, these values are undermined by the capriciousness of a global market economy and the fleeting consent of a constantly changing group of superiors and coworkers. The new economy has created a new ethic, one that encourages us to adopt a situational view of morality, demands that we choose the course of action that maximizes immediate profits, and justifies any decision that maximizes individual economic gain. When combined with rhetoric that shifts our attention away from situations and systems, treating ethics as situation-bound triggers a loss of deeply held moral character. It may be a rational adaptation to contemporary society, but it also may mean that profit and property are the only stable anchors that we have left.

## DISCUSSION QUESTIONS

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1. Is it ethical for a government to act in ways that “socialize” financial *risks* or *losses*? Is it ethical to do so while *privatizing* gains/profits? Or to do so in ways that favor wealthier citizens while imposing risks on less wealthy taxpayers (or vice versa)? Or that create *moral hazards*? Why or why not? Are there social goals that are so important that they would lead you to change your answer?
2. Put yourself in the shoes of a person running a small, local S&L in the late 1980s. If you refuse to take on risk, something that you have always tried to do, depositors will move their funds to riskier investments, which offer higher interest rates. Eventually your S&L could be bankrupt. Your depositors will be protected by federal insurance, but you, your employees, family, and community will suffer. Alternatively, you could do what many of your peers are doing—make riskier investments. If you make good choices, your S&L may survive, and you could become very rich in the process. If you do not, it will go bankrupt sooner. What is the ethical thing for you to do? Why?
3. Now pretend that it is 2005 and you just graduated from college, got married, and landed an entry-level job in one of the booming economies of Southern California, Nevada, or Florida. You like your apartment but keep reading about low interest rate home loans that are available to people who have not saved up the “old-fashioned” 20% down payment. You also vividly remember messages from your childhood telling you that renting is a waste of money because it does not build equity. You

also *feel* that you won't have really become an independent, mature person until you own your home (or at least your own mortgage). Home prices are skyrocketing, and if you wait until you've saved a standard down payment, houses will be much more expensive. You find a house that both you and your partner love. Your banker shows you a way to buy the house at payments you can afford, as long as *both* of you keep your jobs. You know it's risky to commit that high a percentage of your income to housing, but you also know that interest rates may never again be this low. Would it be ethical to take the bank's offer? Will ethical considerations determine what you do? Should they? Why or why not?

4. Your new job is as a bank loan officer; your partner's job is as a construction engineer specializing in housing developments. A young couple just like you apply for a mortgage in hopes of buying a house in one of the subdivisions that your partner helped build. They don't qualify for a standard mortgage or even a standard variable rate mortgage, but they would qualify for a "subprime" package. You worry about them because you've discovered that there are a lot of hidden costs in homeownership, which have made your financial life stressful. But you need a big year-end bonus to cover those costs, and it will be based on the number and value of the mortgages you write. Turning them down would reduce your bonus and make your shaky finances even shakier. What would you do? Would ethical considerations enter into your decision making? Should they? Why or why not? What will you say when you explain your decision to your partner?
5. The Federal Debt Reduction Commission recently recommended that *both* mortgage-related subsidies and tax breaks from the federal agencies that help middle- and lower-income families buy homes be scaled back or eliminated. The Obama administration has proposed taking the latter step, eliminating Fannie Mae and Freddie Mac but doing nothing about the incentives and tax breaks that benefit wealthier taxpayers (Morgenson, 2011a; Wagner & Kravitz, 2011). Is their proposal ethical? Why or why not?

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