LINDA K. TREVIÑO | KATHERINE A. NELSON

MANAGING BUSINESS ETHICS

STRAIGHT TALK ABOUT HOW TO DO IT RIGHT

Seventh Edition

WILEY

Managing Business Ethics

STRAIGHT TALK ABOUT HOW TO DO IT RIGHT

Seventh Edition

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PREFACE

Why Does the World Need Another Business Ethics Text?

The popular business press is replete with feature stories describing ethical meltdowns and how those corporate misdeeds have eroded the public trust of business leaders and their organizations. As most of us learned at our parents' knees, trust and reputation are built over many years and take but an instant to be destroyed. So here we stand at a crossroads. Is it going to be business as usual for business? Or are businesspeople going to commit to regaining the trust of our peers, our families, and our fellow citizens?

In response to this crisis of trust, universities across the country have designed new courses that incorporate leadership, communication skills, the basics of human resources management, and ethics. That's why we wrote this book; we want to make the study of ethics relevant to real-life work situations. We want to help businesspeople regain the trust that's been squandered in the last few years. This book is different from other business ethics texts in several key ways. First, it was written by an unusual team. Linda Treviño is Distinguished Professor of Organizational Behavior and Ethics in the Management and Organization Department of the Smeal College of Business at the Pennsylvania State University. Her prolific research on the management of ethical conduct in organizations is published in the field's best journals and is internationally known and referenced. She has more than 25 years of experience in teaching students and executives in university and nonuniversity settings, and she also has experience as a corporate consultant and speaker on ethics and management issues. Kate Nelson is a full-time faculty member at the Fox School of Business at Temple University in Philadelphia, where she teaches management, business ethics, and human resources to undergraduates. Before joining Temple's faculty, Kate worked for more than 30 years in strategic organizational communication and human resources at a variety of companies including Citicorp, Merrill Lynch, and Mercer HR Consulting. She also has worked as a consultant specializing in ethics and strategic employee communications and has designed ethics programs for numerous organizations. We think that bringing together this diverse mix of theory and practice makes the book unique.

Second, the approach of this book is pragmatic, and that approach is a direct response to complaints and suggestions we have heard from students, employees, and corporate executives. "Make it real," they have said. "Tell us what we need to know to effectively manage people. Take the mystery out of this subject that seems so murky. Get to the point." This book starts with the assumption

that ethics in organizations is about human behavior in those organizations. Research finds that behavior results from a number of factors, many of which can be influenced by managers and the organizations themselves. As a result, this book is organized into sections about individuals, managing in an organizational context, organizations in their broader environment, the ethical dilemmas managers face, and how they might solve them. It also features philosophical and psychological factors of decision making, ethical culture, how managers can influence employees' behavior through ethical leadership, what corporations are doing to encourage ethical behavior and corporate social responsibility, and international business ethics.

Third, we have used a different mix of examples than is found in conventional business ethics texts. Most texts focus on high-level, corporate dilemmas: "Should senior executives be paid at a particular level? Should this industry do business in China? Should American environmental laws apply to American companies operating overseas?" Although these are interesting issues, the vast majority of students and employees will never have to face them. However, they will have to hire, manage, assess performance, discipline, fire, and provide incentives for staff, as well as produce quality products and services and deal effectively and fairly with customers, vendors, and other stakeholders. As a result, although we do feature some classic and recent corporate ethics cases, many of the cases in this book center on the kinds of problems that most people will encounter during the course of their careers. All of the "hypothetical" cases in this text are based on actual incidents that have happened somewhere—it's the real stuff that goes on every day in offices across the country.

Fourth, this book was developed with the help of students at a number of universities and with guidance from numerous managers and senior executives from various corporations and organizations. We have incorporated the latest research on ethics and organizational behavior into this text, and much of the material that appears within these pages has been tested in both university and corporate settings.

Fifth, we believe this book is easy to use because it is organized to be flexible. It can be used alone to teach an ethics course, or it can be used as a supplement to a more conventional, philosophical text. The sections in this book basically stand alone and can be taught in a different sequence than is presented here, and the book also has many cases and vignettes you can use for class discussion. Wiley will create custom versions of the text with selected chapters if requested to do so. To help teach this course, the instructor's guide provides resources such as outlines, overheads, discussion questions, and additional cases for class discussion; it also supplies references to many other resources that can be used to teach the course.

A Note to Students

This book was written for you. We have listened to your complaints and your wish lists and have tried to pare this complicated subject down to a digestible size. The cases that appear in this book all happened to people just like you,

who were not as prepared to deal with the dilemmas as you will be after taking this course. Before you get into this book, we have one suggestion: know that regardless of how large an organization you find yourself in, you're not some little cog in a giant wheel. You have the power to change not only your own behavior and knowledge of ethics but also the behavior and knowledge of the people you work with. Use that power: the job you save may be your own.

We also want to suggest that when interviewing for your next job, you try to make sure that you're joining an organization that values ethics. Are ethics and values described in the firm's recruiting materials? Do organizational representatives talk about ethics and values during their interviews with you? When you ask about how their organization demonstrates ethics and values, does your interviewer respond enthusiastically, or does he or she look like a deer caught in headlights so you instantly know that he or she has never even considered this question before? It's much easier to get into an ethical organization in the first place than try to get out of an unethical one later on.

ACKNOWLEDGMENTS

It takes a lot of work by a lot of people to make a project like this come together. We begin with some joint thank-yous. Then, because this process has been so meaningful for each of us, we separately share our more personal thanks.

We both offer our heartfelt appreciation to current and former executives who helped us with this and previous editions, in particular, Larry Axline, Jeffrey Braun, Jacquelyn Brevard, Earnie Broughton, Craig Cash, Frank Daly, Kent Druyvesteyn, Dennis Jorgensen, John O'Byrne, Kevin O'Connor, Joe Paterno, Robert Paul, Jo Pease, Shirley Peterson, Vin Sarni, Carl Skooglund, Phil Tenney, and George Wratney. All shared their valuable time and advice, some of them on multiple occasions. Their wisdom can be found throughout this book but especially in Chapter 6. They helped bring the subject of managing business ethics to life.

We also wish to thank Gary Weaver (University of Delaware) for being our philosophy adviser for the first edition, and Dennis Gioia (Penn State faculty member and dear friend) for sharing his Pinto fire case and especially his reflections.

John Wiley & Sons, Inc. is a fine publisher with a superb team. These people encouraged, nudged, nudged, and nudged again. We have many Wiley people to thank for helping to make this book a success.

The book's past and present reviewers also contributed significantly to making this a better book, and we thank them as well. We also thank our students and particularly Penn State undergraduate, MBA, and Executive MBA students who provide us with excellent feedback and advice semester after semester.

SPECIAL ACKNOWLEDGMENTS—FROM LINDA K. TREVIÑO

I have always wondered what makes people do especially good and bad things. As the child of Holocaust survivors, I have a unique perspective on and curiosity about such issues. My parents and their families escaped Nazi Germany before Hitler began killing Jews en masse, but not before my maternal grandfather was severely beaten and not before my fraternal grandfather was taken to a concentration camp (euphemistically referred to as a "work camp" at the time). My father's family received papers allowing them to emigrate from Germany to the United States shortly before the war began (in spring 1939), allowing my grandfather to be released from the camp where he was being held (once they were able to find him!). Both families landed in New York, where they survived through sheer grit, perseverance, and belief in the American dream. Although

my family never dwelled on their experiences in Germany, I grew up with a special sensitivity and concern for equality and fair treatment.

I traveled to Germany with my dad and brother about 35 years ago. We visited the tiny towns where Mom and Dad were born and met some wonderful German people who had helped them or at least tried to. I walked through a German village holding hands with the elderly woman who had been my maternal grandmother's best friend and who urged the family to leave Germany because she anticipated the worst. I met another elderly woman who had cared for my father and aunt when they were children and who tried to take care of their home when they were forced to leave everything behind. These were special people, and the opportunity to connect with them holds a special place in my heart. So my family and background influenced me in ways I can't fully grasp with my mind but in ways that I feel in my soul. And I know that my quest to understand what makes people do good and bad things has something to do with that influence.

Many special people have helped along the path that brought me to the writing of this book. I'll begin by thanking my mentors in the doctoral program at Texas A&M University's management department. Many thanks to Stuart Youngblood (now retired from Texas Christian University), Don Hellriegel, Richard Woodman, Dick Daft (now at Vanderbilt University), and Mary Zey, who encouraged my early theorizing and research in business ethics. They told me to go with my gut and to do what was important, and they supported my every step despite the fact that the topic was viewed as risky for my career at the time. My exceptional colleagues in the Management and Organizational Department at Penn State have also been supportive all along the way. They have read my papers and challenged me to think harder and make my work ever better.

My thanks also to the colleagues and doctoral students who have worked with me on ethics-related research over the years and who have been partners in learning about the management of business ethics: particularly Gail Ball, Derron Bishop, Michael Brown, Ken Butterfield, Niki den Nieuwenboer, James Detert, David Harrison, Laura Hartman, Jennifer Kish Gephart, Glen Kreiner, Don McCabe, Bart Victor, Gary Weaver, Jim Detert, Celia Moore, David Mayer, and more. This shared learning has contributed to the book in important ways. I should also thank colleagues whose work fills the pages of the book. The behavioral ethics field has blossomed in recent years and the book has benefited as a result.

Shortly after becoming a faculty member at Penn State, I had the good fortune to meet my friend and coauthor, Kate Nelson. I was intrigued by a brief *Wall Street Journal* article about Kate's work at Citibank (you'll read more about that later). We met and became fast friends, who (believe it or not) loved talking about business ethics. We decided to write an article together, and the rest, as Kate says, is history. Kate brought the real world into this book. She was also willing to tell me when I was getting too academic (not her words exactly). It became clearer and clearer to me that we were supposed to write this book together, and I'm very glad we did. Thanks, Kate!

The article became a book proposal that we first shared with publishers at the Academy of Management meeting in 1992 (25 years ago now). Shortly thereafter, Bill Oldsey (formerly publisher at John Wiley & Sons, Inc.) showed up in my office at Penn State. His enthusiasm for the book was immediate and infectious, and he talked us into writing a textbook rather than a trade book. I want to thank Bill for the special part he played.

Over the years, Penn State colleagues, administrators, and donors have continued to support my efforts in the area of business ethics. I am grateful to the Cook family, especially the late Ann Cook, for supporting business ethics at Smeal and the Cook Fellowship that I held for a number of years. My thanks also to Mrs. Mercedes Shoemaker (and her late husband, Albert) for supporting the Shoemaker program in Business Ethics that has brought us wonderful speakers on the topic of business ethics year after year. Finally, I am especially grateful to Dean James Thomas for naming me Distinguished Professor of Organizational Behavior and Ethics. My association with the Ethics and Compliance Initiative's (formerly the Ethics Resource Center) Fellows program (see *www.ethics.org*) has connected me with executives who manage ethics in large business organizations as well as consultants and those in government who are interested in making the business world (and the rest of the world, for that matter) a more ethical place. I appreciate the relationships and the learning that have come from this association as well as the time these executives have shared with me. In particular, I appreciate the funding that this group has provided for research that has found its way into this book, especially research on executive ethical leadership.

My heartfelt thanks also go to family members, colleagues, and many dear friends not only for cheering me on (as usual) but also for their many contributions to this book. They have served as readers and interviewees. They have provided clipping services, helped me make contacts, and offered ideas for cases. They were there when I was overwhelmed. I can't thank them enough. Finally, I thank the light of my life, Dan, for the inspiration, love, and support he provides every day of my life and for being one of the most ethical human beings I know.

SPECIAL ACKNOWLEDGMENTS—FROM KATHERINE A. NELSON

I began to learn about ethics and integrity as a very young child in a family where "doing it right" was the only option. I was blessed to grow up hearing about how your reputation is priceless and you must always guard it and act in ways that enhance that reputation. As a result, my biggest debt is to my parents, the late Harry R. and Bernadette Prendergast Nelson (formerly of New Hartford, New York), and my brother, James V. Nelson of Pasadena, California. My parents worked tirelessly to set Jim and me on the right path, and Jim's generosity and enthusiastic support encouraged me not only to teach ethics but also to write this book. (Jim proved to me that one can be an investment banker and

have high ethical standards, and I'm very proud of him.) I'm also grateful to Jim's wife, Susan, for her many encouraging words of support and for giving our family its two most precious additions, Conor Vincent and James Patrick Nelson. Recently, I was delighted to hear one of my nephews opine about business success. He said, "I want to work for a good company and when I say 'good,' I don't mean just profitable. I mean I want to work for a company that does good things." He could not have made me happier.

Thanks to my dearest friends, for their friendship, love, and support: Debra Besch, Loren Hart, Elizabeth Dow, Carol Dygert, and Gail Martin. Thanks also to the educational institutions that provided me with a sound footing in values: Utica Catholic Academy (UCA) in Utica, New York, and the College of Mount St. Vincent in Riverdale, New York. A special thank you to Rev. Laurence Kennedy, who not only taught me philosophy and ethics at UCA, but who also corresponded with me afterward, trying to answer this young girl's questions about morality and our obligations to others.

If I had ever known how much fun it is to teach, I might have made the transition to academia much earlier. Many thanks to the deans at the Fox School of Business at Temple University—including Moshe Porat, Rajan Chandran, Diana Breslin Knudson, and Debbie Campbell, who took a chance on my teaching ability—and thanks to my many students past and present, who have enriched my life in ways I could not have imagined. Sincere thanks also to my many colleagues at Temple, who were so welcoming to this corporate refugee and who make me feel so much a part of this wonderful institution, especially Deanna Geddes, John McClendon, Andrea Brooks Lopez, Debbi Casey, and Kathleen Voss.

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The most important thank-you goes to my wonderful husband, Stephen J. Morgan—an honorable man if there ever was one—who inspires and loves me every day. This book and my teaching would not be possible without his unfailing support, wisdom, and encouragement.

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SECTION I

Introduction

CHAPTER 1

Introducing Straight Talk about Managing Business Ethics: Where We're Going and Why

Introduction

Back in 1993, when we sat down to write the first edition of this book, people wondered if business ethics was just a fad. At that point, companies were just beginning to introduce ethics into new-hire orientations and management training programs. In academia, business ethics was just beginning to gain traction as a subject for serious academic study, and some business schools were going so far as to require a business ethics course to graduate.

Back then there was still the feeling among many experts that business ethics—like time management, quality circles, and other management buzzwords of the day—would soon become a footnote in texts that described business fads of the late twentieth century. Despite multiple waves of scandal over the years, these have often been portrayed as temporary blips. For example, one prominent business writer for *Fortune Magazine* wrote an article in 2007 titled "Business is Back!" Here's a choice excerpt: "It must be said: The shaming is over. The 5½ year humiliation of American business following the tech bubble's burst and the Lay-Skilling-Fastow-Ebbers-Kozlowski-Scrushy perp walks that will forever define an era has run its course. After the pounding and the ridicule, penance has finally been done. No longer despised by the public, increasingly speaking up and taking stands, beloved again by investors, chastened and much changed—business is back."[1] Could he have been more wrong? Business managed to outdo itself on the shame index yet again just about a year later with the collapse of the financial markets. We've seen these ethical debacles occur regularly for the past 30 years. As a result, we're convinced that business ethics is far from a fad. It's an ongoing phenomenon that must be better understood and managed and for which business professionals must be better prepared.

We tell our students that serious ethical scandals often result from multiple parties contributing in their own small or large ways to the creation of a catastrophe. As you'll read later on in this book, Enron's collapse in 2001 was not just the failure of Enron executives and employees, but also the failure of Enron's auditors, the bankers who loaned the company money, and the lawyers who never blew the whistle on Enron's shenanigans. However, no scandal of recent

years—not even Enron—matches the financial industry debacle in 2008. Like Enron, many players contributed to this colossal failure. But the financial crisis was unparalleled in its scope and has fueled public outrage like no other business disaster in our lifetime. The aftermath had people around the world angry and mistrustful of companies, governments, regulators, rating agencies, and the people who work in them. If there was ever a crisis of trust and confidence, this is it. It is also a textbook-perfect example of how numerous people's actions (and inactions) can conspire to spawn an almost unimaginable calamity.

Recent business history has proven beyond any doubt that divorcing business from ethics and values runs huge risks. Rushworth Kidder,[2] the highly regarded ethics writer and thinker who died in 2012, wrote about the financial debacle and the resulting public anger. He eloquently described how free marketers cite Adam Smith's *Wealth of Nations* to justify a breed of capitalism that abhors regulation and focuses on short-term profits over long-term stewardship. Kidder wisely noted that 17 years before his more famous book, Smith wrote another one titled *The Theory of Moral Sentiments*. Smith's first book deserves more attention because he always presumed that the messages from these two books would go hand in hand. Smith's "moral sentiments" work rests on the assumption that human beings are empathetic; they care about others, and they derive the most joy from human love and friendship. His book opened with the following statement: "How selfish soever man might be supposed, there are evidently some principles in his nature, which interest him in the fortune of others. . . ."[3] Smith believed that a good life derives from the expression of "beneficence," not from material wealth. He proposed that self-love (which he also acknowledged) can spur the individual to better his own condition by besting competitors. But he argued that this must be done in a just manner and in the spirit of fair play as judged by an informed, ethical, and impartial spectator. We care what others think of us because we are first and foremost social beings. But we also are moral beings who want to do the right thing because it is the right thing to do (not just to win the praise of others). According to Smith, virtuous persons balance prudence (mature self-love), strict justice, and benevolence, and ideal societies are comprised of such persons. Finally, a flourishing and happy society is built upon a foundation of justice and rules of conduct that create social order. Smith was confident that humankind would progress toward this positive ethical state; he called on leaders to avoid the arrogance of power and, instead, to be virtuous statesmen. Kidder's point was that capitalism will succeed only when firmly tethered to a moral base, and he reminds us that Adam Smith—that hero of free marketers—knew this better than anyone.

We completely agree. We began this book more than 20 years ago with the firm belief that business isn't just "better" when companies and businesspeople are ethical, but rather that good ethics is *absolutely essential* for effective business practice. This is not just empty rhetoric. Work is essential to life, and most people work for a business of some kind. How we work and the standards we uphold while we are working affect much more than just commerce. Our business behavior also affects our personal and company reputations, politics, society at large, and even our national reputation. For example, the 2008 financial crisis,

while global in scope, had its roots in the United States, and the nation's reputation has suffered because of the behavior of individuals and companies. Similarly, China's reputation has suffered because of contaminants found in Chinese exports such as infant formula, drywall (used in construction), and children's toys. So corporate misbehavior does not happen in a vacuum, and it's not just corporate reputations that suffer as a result. These scandals cast long shadows, and they often affect entire industries and countries. In this complex and increasingly transparent world, where reputation influences everything from who wants to hire you or trade with you to who buys your products to who finances your debt—and much more—unethical behavior in business is a very big deal indeed. So let's take a closer look at the elephant in the room: the near collapse of the financial markets in 2008 and what it has to do with business ethics.

The Financial Disaster of 2008

The implosion of the financial markets in 2008 was largely not the result of illegal behavior. For the most part, the activities that brought down the U.S. economy and others around the world were not against the law, at least not yet (government regulators and the legal system often play catch-up after ethical debacles in business). Many of those activities, however, were unethical in that they ultimately produced great harm and were contrary to a number of ethical principles such as responsibility, transparency, and fairness. Let's start with some of the factors that laid the groundwork for the disaster in the United States.

Borrowing Was Cheap

First, borrowing money became really cheap. In 2000, stocks in high-technology companies had soared to unsustainable heights, and that bubble finally burst. To soften the effects on the U.S. financial markets, Alan Greenspan, who headed the Federal Reserve at that time, lowered the Federal Funds rate (the rate banks charge each other for overnight loans, which has a direct impact on short-term interest rates, including the prime rate) to almost zero. That move, seemingly innocent at the time, injected huge amounts of money into the U.S. financial system. It made the cost of borrowing so low that it fueled a glut of consumer borrowing. Suddenly, it was amazingly cheap to buy a new car, a wide-screen television, a backyard pool, a larger home, a second home, and all sorts of designer goodies. There was even encouragement to indulge. Following the terrorist attacks in September 2001, President George W. Bush told people that if they wanted to help the economy they should go shopping. And people did. Household debt levels rose to $13.9 billion in 2008, almost double what households owed in 2000, and savings dipped into negative territory. Responsible borrowers should have thought about what they could afford rather than what bankers would lend to them. And responsible lenders should have established that borrowers could actually afford to pay back the loans before lending them money.

Real Estate Became the Investment of Choice

Of course, people also want to invest in something safe, and what could be safer than real estate? There had been relatively few instances of real estate values declining, and when they did the declines were generally shallow and short-lived. A point of pride in the United States was the high percentage of Americans who owned their own homes. Investing in a home traditionally had been a very safe investment and one that was slow to appreciate in value. But suddenly in the early 2000s, real estate investing became a real moneymaker. With a backdrop of historically low interest rates, real estate became such a popular way to invest that demand soon outstripped supply and prices soared. The value of homes skyrocketed—homes that were selling for $300,000 in one year sold for $450,000 the next. Prices rose so fast that speculation grew tremendously. People bought houses with almost no down payment, remodeled them or waited a few months, and then resold the houses for a quick profit. A number of popular television programs showed viewers how to “flip” real estate properties for profit.

Because the cost of borrowing was so low and home equity had grown so quickly, many consumers borrowed on the equity in their homes and purchased additional real estate or a new car or financed a luxury vacation. For example, suppose someone purchased a house for $500,000 in 2003. By 2005, the home might have been worth $800,000. The home owner refinanced the mortgage—borrowing as much as the entire current worth of the house (because its value could only go up, right?), which resulted in a $300,000 cash infusion for the home owner. This practice was very popular, and it laid the groundwork for a huge disaster when the housing values fell off a cliff in 2008 and 2009. Imagine the home owner who refinanced the home just described. Imagine that he took the $300,000 and purchased a summer home and a sports car and paid for his children’s college educations. Suddenly, home values plummeted and his house lost 30 percent of its value, which was common in markets such as California, Florida, Nevada, and Arizona, where the real estate bubble was particularly inflated. After the real estate bubble burst, his house was worth $560,000. Now suppose he loses his job and needs to sell his house because he can’t afford the mortgage payments. He can’t get $800,000 for his home, which is what he owes on his mortgage. His only choice is to work with the mortgage holder (probably a bank) to refinance (unlikely) or declare bankruptcy and walk away from the house. This is what a lot of home owners have done, and it is one of the factors at the heart of the current financial crisis. Lots of folks were in on this bubble mentality, getting what they could in the short term and not thinking very much about the likelihood (or inevitability) that the bubble would burst.

Mortgage Originators Peddled “Liar Loans”

In the early 2000s, as housing investments increased in popularity, more and more people got involved. Congress urged lenders Freddie Mac and Fannie Mae to expand home ownership to lower-income Americans. Mortgage lenders began to rethink the old rules of financing home ownership. As recently as the

late 1990s, potential home owners not only had to provide solid proof of employment and income to qualify for a mortgage, but they also had to make a cash down payment of between 5 and 20 percent of the estimated value of the home. But real estate was so hot and returns on investment were growing so quickly that mortgage lenders decided to loosen those "old-fashioned" credit restrictions. In the early 2000s, the rules for obtaining a mortgage became way less restrictive. Suddenly, because real estate values were rising so quickly, borrowers didn't have to put any money down on a house. They could borrow the entire estimated worth of the house; this is known as 100-percent financing. Also, borrowers no longer needed to provide proof of employment or income. These were popularly called "no doc" (no documentation) or "liar loans" because banks weren't bothering to verify the "truth" of what borrowers were claiming on their mortgage applications.

This complete abandonment of lending standards opened the mortgage market to rampant fraud, and it was not exactly a secret. The FBI warned of an "epidemic" of mortgage fraud back in 2004, four years before that epidemic torpedoed the financial industry.[4]

Banks Securitized the Poison and Spread It Around

At about the same time liar loans were becoming popular, another new practice was introduced to mortgage markets. Investors in developing countries were looking to the United States and its seemingly "safe" markets for investment opportunities. Cash poured into the country from abroad—especially from countries like China and Russia, which were awash in cash from manufacturing and oil, respectively. Wall Street bankers developed new products to provide investment vehicles for this new cash. One new product involved the securitization of mortgages. (Note: structured finance began in 1984, when a large number of GMAC auto receivables were bundled into a single security by First Boston Corporation, now part of Credit Suisse.) Here's how it worked: Instead of your bank keeping your mortgage until it matured, as had traditionally been the case, your bank would sell your mortgage—usually to a larger bank that would then combine your mortgage with many others (reducing the bank's incentive to be sure you would pay it back). Then the bankers sold these mortgage-backed securities to investors, which seemed like a great idea at the time. Real estate was traditionally safe, and "slicing and dicing" mortgages divided the risk into small pieces with different credit ratings and spread the risk around.

Of course, the reverse was also true, as the bankers learned to their horror. This method of dividing mortgages into little pieces and spreading them around could also spread the contagion of poor risk. However, starting in 2002 and for several years thereafter, people couldn't imagine housing values falling. So much money poured into the system, and the demand for these mortgage-backed security products was so great, that bankers demanded more and more mortgages from mortgage originators. That situation encouraged the traditional barriers to getting a home mortgage to fall even farther. These investment vehicles were also based upon extremely complex mathematical formulas

(and old numbers) that everyone took on faith and few attempted to understand. It looks like more people should have followed Warren Buffett's sage advice not to invest in anything you don't understand!

Add to that toxic mix the relatively new idea of credit-default swaps (CDS). These complex financial instruments were created to mitigate the risk financial firms took when peddling products such as securitized mortgages. CDS are insurance contracts that protect the holder against an event of default on the part of a debtor. One need not own the loan or debt instrument to own the protection, and the amount of capital tied up in trading CDS is very small compared to trading other debt instruments. That is a very significant part in the increase in the popularity of CDS at sell-side and buy-side trading desks. The insurance company AIG was a huge player in this market, and so were the large banks. The firms that were counterparties to CDS never stepped back from the trading frenzy to imagine what would happen if both the structured finance market and the real estate bubble burst (as all bubbles eventually do) at the same time. Both underwriters and investors would be left holding the bag when the music stopped playing—and the U.S. taxpayer has had to bail out most of the financially stressed firms to save the entire financial system from collapse. Please note that all of this happened in a part of the market that was virtually unregulated.

Those Who Were Supposed to Protect Us Didn't

One protection against financial calamity was thought to be the rating agencies, including Standard and Poor's, Fitch Group, and Moody's. They rate the safety or soundness of securities, including those securitized mortgage products. A credit opinion is defined as one which rates the timeliness and ultimate repayment of principal and interest. But, like everyone else, the rating agencies say they didn't foresee a decline in housing prices; and consequently, they rated the mortgage securities as being AAA—the highest rating possible, which meant that the rating agencies considered these securities to be highly safe with little risk.

The agencies are the subject of much criticism for their role in the crisis. If they had done a better job analyzing the risk (their responsibility), much of the crisis might have been avoided. But note that these rating agencies are hired and paid by the companies whose products they rate, thus causing a conflict of interest that many believe biased their ratings in a positive direction. So people who thought they were making responsible investments because they checked the ratings were misled.

Another protection that failed was the network of risk managers and boards of directors of the financial community. How is it that one 400-person business that was part of the formerly successful insurance behemoth, AIG, could invest in such a way that it brought the world's largest insurance company to its knees? The risk was underestimated all around by those professionals charged with anticipating such problems and by the board of directors that didn't see the problem coming. The U.S. government (actually taxpayers) ended up bailing

out AIG to the tune of $170 billion. The risk managers and boards of other financial firms such as Citigroup, Merrill Lynch, Lehman Brothers, Bear Stearns, and Wachovia were similarly blind.

On Wall Street, there were other contributing factors. First, bank CEOs and other executives were paid huge salaries to keep the price of their firms' stocks at high levels. If their institutions lost money, their personal payouts would shrink. As a result, bank executives focused on short-term financial results often to the exclusion of long-term planning or organizational strategy. Because their compensation packages were directly tied to the company stock price, they were paid handsomely for their efforts to bolster short-term profits. The Wall Street traders were similarly compensated—they were paid multimillion-dollar bonuses for taking outsized risks in the market. What seemed to matter most were the short-term profits of the firm and the short-term compensation of those making risky decisions. The traders took risks, the bets were at least temporarily successful, and the bankers walked off with multimillion-dollar bonuses. It didn't matter that the risk taking was foolish and completely irresponsible in the long run. The bonus had already been paid. Consequently, a short-term mentality took firm root among the nation's bankers, CEOs, and boards of directors.

In addition, most of the big investment banks went public in the 1990s. Before becoming public companies, these firms were mostly partnerships. If the partners wanted to make a bet on the markets, they were risking their own money. If they won the bet, they reaped the rewards as individuals. If they lost the bet, the loss came out of their personal assets. In other words, they had "skin in the game." After these firms went public, the money used to make bets no longer came from the partners; it came from shareholders. The profits and losses from these bets enriched the company directly, not the individuals who ran it (who would benefit only indirectly). These executives no longer had "skin in the game" to anywhere near the degree that they had when these firms were partnerships. It's much easier to get careless with other people's money than it is your own.[5]

If you thought that bankers' behavior would change as a result of the financial debacle, think again. In 2012, JPMorgan Chase—which in the wake of the financial crisis was described by many experts as being the best managed U.S. bank—suffered a huge loss at the hands of a rogue trader in its London office. The initial losses were estimated to be $2 billion, but later revised to be perhaps as high as $9 billion—in the same exact type of investments that created the financial catastrophe just a few years earlier.[6] Between 2008 and 2014, JPMorgan Chase has paid more than $70 billion in fines for a variety of questionable activities. They are not alone. Bank of America has paid fines of $120 billion over the same period and Citigroup has paid more than $38 billion in fines.[7]

Finally, we cannot examine the financial crisis without questioning the role of regulatory agencies and legislators. For example, for a decade, investor Harry Markopolos tried on numerous occasions to spur the Securities and Exchange Commission to investigate Bernard L. Madoff. The SEC never did uncover the

largest Ponzi scheme in the history of finance. The $65 billion swindle unraveled only when Madoff admitted the fraud to his sons, who alerted the SEC and the U.S. attorney's office in New York in December 2008.

Others who are culpable in the financial crisis are members of the U.S. Congress, who deregulated the financial industry, the source of some of their largest campaign contributions. Among other things, they repealed the Glass-Steagall Act, which had been passed after the U.S. stock market crash in 1929 to protect commercial banking customers from the aggression and extreme risk taking of investment bank cultures. The act created separate institutions for commercial and investment banks, and they stayed separate until Citicorp and Travelers merged to form Citigroup in 1998. The two companies petitioned Congress to eliminate Glass-Steagall, claiming that it was an old, restrictive law and that today's markets were too modern and sophisticated to need such protection. And Congress listened.

Those 1930s congressmen knew that if the two banking cultures tried to exist in the same company—the staid, conservative culture of commercial banking (our savings and checking accounts) and the razzle-dazzle, high-risk culture of investment banking—the "eat what you kill" investment bank culture would win out. Some said that staid old commercial banks turned into "casinos." But, interestingly, casinos are highly regulated and are required to keep funds on hand to pay winners. In the coming years, we expect to learn more about the behavior that led to this crisis. As we noted earlier, much if not most of it was probably legal because of the lack of regulation in the mortgage and investment banking industries. But look at the outcome! If only ethical antennae had been more sensitive, more people might have questioned products they didn't understand, or spoken out or refused to participate in practices that were clearly questionable. As just one tiny example, could anyone have thought it was ethical to sell a product they called a liar loan, knowing that the customer surely would be unable to repay (even if it was legal to do so)?

In 2010, the U.S. Congress passed the Dodd-Frank Financial Regulation Legislation—an attempt to rein in the most egregious practices in the financial industry. Financial institution lobbyists continue trying to water down the effects of this bill as regulators work to implement its complex regulations. Several European countries might be ahead of the U.S. when it comes to comprehensive financial regulation reform.[8] Although many experts felt that Dodd-Frank was a failure in the years immediately following the crisis, the view is more nuanced now, going on ten years after the crisis. While more than a few banks remain "too big to fail," bank profits are down, capitalization is up, and some experts theorize that the banks are indeed shrinking as a result of the regulation.[9]

What's increasingly clear is that corruption exists among the world's leading financial institutions and that sometimes they collude in that corruption. If you think that is an exaggeration, please read about the LIBOR scandal that broke during the summer of 2012. LIBOR, which stands for the London Interbank Offered Rate, is the interest rate by which banks can borrow from one another. LIBOR is important because so many of the loans around the world—mortgage