MIDWEST STUDIES IN PHILOSOPHY

EDITED BY
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Sophisticated financial activity is seldom studied in analytic philosophy. This collection is a preliminary and partial attempt at addressing the neglect of that topic. It is occasioned by the tenth anniversary—in 2018—of the Global Financial Crisis. The Global Financial Crisis is also the medium through which some of the moral and metaphysical issues raised by high finance are pursued in what follows.

The background to the crisis is well known to specialists. A fall and then a collapse in U.S. real estate prices after 2006 ushered in a complex series of defaults, runs, and liquidity problems that badly affected not only Wall Street but also European financial markets and, eventually, financial markets everywhere. The crisis was not very visible to the general public until the New York investment bank, Lehman Brothers, went out of business in September 2008. After that, severe stock market disruption and credit shortages dominated the headlines. Many other U.S. banks came close to failure, and so did others in the United Kingdom and Continental Europe.

The crisis was not an act of God. It resulted from, among other things, the creation and operation of markets in exotic financial instruments. Many of the inventors of the instruments and participants in the markets made a lot of money up to 2006, and they are among the people who have been blamed for the vast losses that were suffered afterward. Agents can only be blamed for what they are responsible for. But which agents does it make sense to say are responsible for bad outcomes on the scale and of the complexity of the financial crisis? Perhaps only large, institutional actors: governments, or government-appointed regulatory
agencies, corporations, including banks. The U.S. Financial Crisis Investigatory Committee\(^1\) is scathing about the bodies in the United States that oversaw banks both before and after 2006. The channels for lobbying available to banks are also made much of in arguments to the conclusion that the regulatory system was weakened by legislators to the advantage of banks. These and other arguments for assigning responsibility are considered by many of the essays in this edition of *Midwest Studies in Philosophy*.

Virtually no one thinks that a small group of powerful institutions, still less a few powerful individuals, have responsibility for the crisis as a whole. But responsibilities in the crisis are a different matter. Journalists have made lists of some of the supposedly guilty parties and their personal misdeeds: are those attributions of responsibility defensible, or are they only a way of personalizing, perhaps unjustifiably, a complex set of decisions, many of which were reasonable from the point of view of those involved? This volume considers some of the philosophical issues raised by both general and highly personalized attributions of responsibility. Some of the issues are conceptual. Without the financial crisis in mind, philosophers have sketched conditions for attributing collective rather than individual responsibility for various kinds of outcomes. Perhaps that concept of responsibility fits the financial crisis better than the more homely notion of individual responsibility. Or perhaps, more impersonally conceived economic forces are in play.

Assignments of responsibility are often couched in a variety of narratives of the crisis. Indeed, much popular discussion, in the media and in politics, uses narratives of the crisis to support a favored account of where responsibility for the effects of the crisis, or particular aspects of the crisis, should lie. This collection also makes use of narratives, but not in the same way as popular discussion. Popular narratives of the crisis are very often presented as mutually exclusive. That is, they are used to focus blame on one party to the crisis while simultaneously exculpating some other party or parties. The narratives given in this book, by contrast, are often complementary.

We can distinguish in the narratives between the more-or-less agreed description of the events that constituted the crisis, and the factors that according to the narratives account for those events. The remainder of this introduction sets out some of the events that are central to any description of the crisis. It then captures some of the main explanations that have been offered and links these with the essays that follow.

1. THE MAIN EVENTS OF THE CRISIS (2007–08)

The financial crisis started in earnest when big financial institutions, particularly in the United States, were driven into bankruptcy, or threatened with bankruptcy, by losses in the subprime mortgage market. Table 1\(^2\) provides a chronology of important events, beginning in 2007.


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**Table 1. Financial Crisis Major Events Timeline**

<table>
<thead>
<tr>
<th>Year</th>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>August</td>
<td>Problems in mortgage and credit markets spill over into interbank markets; haircuts on repo collateral rise; asset-backed commercial paper issuers have trouble rolling over their outstanding paper; large investment funds in France freeze redemptions.</td>
</tr>
<tr>
<td>2007</td>
<td>August 17</td>
<td>Run on U.S. subprime originator Countrywide.</td>
</tr>
<tr>
<td>2007</td>
<td>September 9</td>
<td>Run on U.K. bank Northern Rock.</td>
</tr>
<tr>
<td>2007</td>
<td>December 15</td>
<td>Citibank announces it will take its seven structured investment vehicles onto its balance sheet, $49 billion.</td>
</tr>
<tr>
<td>2008</td>
<td>December</td>
<td>National Bureau of Economic Research subsequently declares December to be the business cycle peak.</td>
</tr>
<tr>
<td>2008</td>
<td>March 11</td>
<td>Federal Reserve announces creation of the Term Securities Lending Facility to promote liquidity.</td>
</tr>
<tr>
<td>2008</td>
<td>March 16</td>
<td>J P Morgan Chase agrees to buy Bear Stearns, with Federal Reserve assistance, and Federal Reserve announces creation of the Primary Dealer Credit Facility.</td>
</tr>
<tr>
<td>2008</td>
<td>June 4</td>
<td>Monoline insurers MBIA and AMBAC are downgraded by Moody’s and S&amp;P.</td>
</tr>
<tr>
<td>2008</td>
<td>September 7</td>
<td>Federal government takes over Fannie Mae and Freddie Mac.</td>
</tr>
<tr>
<td>2008</td>
<td>September 16</td>
<td>Lehman Brothers files for bankruptcy.</td>
</tr>
<tr>
<td>2008</td>
<td>September 25</td>
<td>Washington Mutual, the largest savings and loan in the U.S. with $300 billion in assets, is seized by the authorities.</td>
</tr>
<tr>
<td>2008</td>
<td>October</td>
<td>Financial crisis spreads to Europe.</td>
</tr>
<tr>
<td>2008</td>
<td>October 3</td>
<td>U.S. Congress approves the Troubled Asset Relief Program, authorizing expenditures of $700 billion.</td>
</tr>
<tr>
<td>2008</td>
<td>October 13</td>
<td>Major central banks announce unlimited provision of liquidity to U.S. dollar funds; European governments announce system-wide bank recapitalization plans.</td>
</tr>
<tr>
<td>2008</td>
<td>October 14</td>
<td>U.S. Treasury invests $250 billion in nine major banks.</td>
</tr>
<tr>
<td>2009</td>
<td>May</td>
<td>Results of the Supervisory Capital Assessment Program (&quot;stress tests&quot;) announced.</td>
</tr>
<tr>
<td>2009</td>
<td>June</td>
<td>National Bureau of Economic Research subsequently declares June to be the business cycle trough.</td>
</tr>
<tr>
<td>2009</td>
<td>October</td>
<td>Unemployment rate peaks at 10.0 percent.</td>
</tr>
</tbody>
</table>
1.1 “Runs” in Many Markets

A way of summarizing what happened during this period is by saying that, at different times, investors in short-term money markets, and retail bank depositors, withdrew their funds or refused to extend loans at maturity, actions which together constituted “runs” in each sector.

A “run” on a retail bank consists of many individual depositors withdrawing their funds at once, at levels that threaten to exhaust the bank’s cash and other reserves. A second kind of “run” took place in money market funds (Table 1 uses the abbreviation MMFs). These were vehicles for the purchase of (typically short-term) commercial securities. Individuals and companies bought easy-to-redeem units or shares in these funds, which made them seem similar to bank deposits. Retail money market funds worked by pooling what were in effect the deposits of small investors into the big amounts needed to buy low-risk, high-return government investments. Wholesale money market funds bought the short-term debt (“commercial paper”) of big companies, including banks, as well as shares. Money market funds were the prototype of the “shadow banking” sector: investments in those funds were perceived as safe on the model of bank deposits, but investments were not insured as bank deposits were, and money market funds did not have to retain capital against redemptions, as institutions with the official and legal status of banks had to do against withdrawal of deposits. Securities backed by mortgages were among those bought on a large scale by money market funds, and when the risks of these were suddenly re-rated upward in 2007, redemptions were also attempted by retail and commercial investors on a large scale. This was the second “run.”

Alongside these runs, the “repurchase” or “repo” market started to seize up. This market involved the sale of securities by commercial firms (often financial services companies) for cash, with an agreement by the sellers to repurchase those securities at a price agreed in advance—a price that gave a return for the use of the cash. The term of the repurchase agreement was typically very short—sometimes overnight—but less often a month or three months. Buyers in repurchase agreements treated the commercial paper they were sold as collateral. In the event of a failure to repurchase at the agreed price, the collateral could be sold. If the collateral sold exceeded the value of the cash lent, the defaulting issuer of the security would take a “haircut” on the sale; if the collateral was equal in value to the cash lent, it would take no “haircut.” The term of the security could also be extended or “rolled over” at maturity by security holders, and, by August 2007, they began to be unwilling to do this.

1.2 The U.S. Subprime Mortgage Market on the Brink

What happened in August was not the first event in the crisis. As Table 1 shows, the beginning of the crisis can be dated to June and July and affected a pair of companies involved in financing subprime mortgages, that is,
high-risk, high-interest house purchase loans. Typically, these were offered to borrowers with relatively low incomes who could only pay relatively small initial deposits. These high-risk loans were aggressively marketed, and, in the early 2000s, often approved without adequate documentation of the borrower’s ability to repay. A combination of factors accounted for the laxity of lending practice in this area. Rising house prices meant that mortgaged properties could often be resold at a profit shortly after they were bought, without a borrower’s ability to repay ever being seriously tested. Relatively uncreditworthy mortgage holders could improve their credit ratings by refinancing mortgages, based on a very brief record of not defaulting on a house loan. This meant that over a short period of time many subprime borrowers could appear better able to repay than they actually were.

In the late 1990s and early 2000s, there were substantial pools of cash in the United States and in other parts of the world whose managers were seeking safe investments. U.S. government securities were a first choice of the managers of these cash pools, but mortgage-backed investments were an increasingly popular alternative. Mortgages held by the U.S. federal agencies, Fannie Mae and Freddie Mac, were attractive because they were relatively prudently originated. But other mortgages, even less well underwritten ones, were also attractive to investors. Many in the market, including U.S. pension funds, and many European and Asian banks, were willing to pay for a share of the mortgage repayments associated with subprime loans, especially if that share got a high rating from a credit-rating agency.

The lax practices of the mortgage originators enabled them to make home loans in sufficient quantities to keep up with demand for “safe” investments like mortgages. New “securitized” financial instruments allowed subprime and other mortgages to be combined and sold on, after first being divided into differently risk-rated “tranches” or slices, the higher risk tranches paying the highest returns. The higher risk tranches of securitized mortgage packages (rated BBB or lower by rating agencies) were themselves repackaged separately into collateralized debt obligations (CDOs). Some of the lower rated BBB tranches from securitized instruments with AAA tranches were, curiously, re-rated as AAA when they were reinserted into CDOs (FCIC, 127–28). These instruments were themselves traded, and they appeared on bank balance sheets as assets, sometimes functioning as collateral in other transactions. Mortgage originators sold these securitized instruments to “structured investment funds”—specially established as receptacles for these securities—and these funds bought the securities through the resale of asset-backed securities to managers of the cash pools already mentioned. At least one very large financial institution, Merrill Lynch, was involved in all aspects of the mortgage market: originating, securitizing, and trading. Citigroup, too, followed this approach. Others were less heavily but still substantially invested in these assets.

The subprime mortgage market in the United States was very vulnerable to a downturn in house prices, and when this occurred, in early 2006, underwriters of those mortgages inevitably suffered. Ownit and New Century Financial...
were the first major casualties in the summer of 2007, as Table 1 shows, but in August, the banking arm of Countrywide, a huge U.S. mortgage provider, experienced a run. Similar runs by retail depositors were experienced a few months later in the United Kingdom by Northern Rock, a mortgage provider financed not by deposits but by borrowing on the money markets.

1.3 The Specter of Bank Failure

A crucial event in the crisis was the failure of an investment bank, Lehman Brothers, in September 2008. Lehman Brothers had borrowed heavily to buy high-risk tranches of securitized mortgages, and these “assets” plummeted in value after the summer of 2007, when Lehman had sold its own subprime mortgage originator. Unable to borrow or agree terms with other banks interested in taking it over, Lehman suffered huge losses and a steep decline in its share price. Its failure affected other institutions, including money market funds that had invested in it, and which were unable to cope with their own set of “runs.” Both mortgage-backed securities and commercial paper issued by big business underwent a steep decline in value in September 2008. The Lehman bankruptcy affected not only money market funds that held its almost worthless shares and its worthless promises to repay, but U.S. money market funds in general.3 One MMF in particular, the Reserve Management Fund, had the distinction of being the first to “break the buck”—to be unable to cover its shares at a net asset value of $1 per share—and this largely because it faced a run from large investors who had heard of its exposure to the Lehman bankruptcy. In addition to its effect on the money market funds, the prospect of the sale of Lehman’s huge property portfolio depressed the values of other real estate holdings. Again, after Lehman’s failure, other investment banks became targets for short selling: traders in the derivatives markets started betting on sharply lower share prices for each of the major Wall Street firms, even the hugely profitable flagship investment bank Goldman Sachs. Lehman thus illustrated the very far-reaching systemic effects of a large Wall Street failure.

Nine months before Lehman went into bankruptcy, seven loss-making structured investment vehicles (SIVs) were taken onto Citibank’s balance sheet, having lost almost half their value in the preceding four months. As already said, structured investment vehicles were specialized finance companies that sold supposedly low-risk, asset-backed short-term bonds and other securities to finance long-term lending, including mortgage lending, at higher interest rates. Before Citibank intervened, the seven SIVs were not among its liabilities: they were part of the shadow-banking regime which existed off its balance sheet. Once they were taken onto Citibank’s books, at a value of $49 billion, it could start to be doubted that Citibank had the sort of balance sheet needed to maintain its “real” or nonshadow-banking activities. Provisions

for huge losses connected to SIVs affected several U.S. banks, including Bank of America and Sun Trust, in the last three months of 2007. Northern Rock in the United Kingdom was in a similar position.

SIVs were vulnerable to two developments: a collapse in the values of their chosen long-term investments, for example through a high rate of mortgage default, and lack of cash when short-term securities matured and investors who did not want to roll them over had to be paid back. The downturn in property prices in the United States engaged both vulnerabilities. Buyers of short-term bonds became scarce, and back-up funding from banks dwindled. Or, in other words, problems of liquidity became threats of bankruptcy. These linked problems of liquidity and solvency are at the heart of the events listed in Table 1. Again and again, SIVs and other institutions that had hugely over-borrowed through short-term loans, and whose mortgage-backed securities were losing value, found themselves unable to borrow more to meet their short-term commitments to repay investors.

1.4 Wider Institutional Distress

The other main casualties of the problems in the U.S. real estate market were insurance companies and the two federal mortgage enterprises, Fannie Mae and Freddie Mac. Fannie Mae started out in 1938 as a government agency providing mortgage finance to private banks investing in government-insured mortgages. In 1968, it was privatized, and in 1970, it was authorized to buy privately originated mortgages. Freddie Mac was created to compete with Fannie Mae with a view to the establishment of an efficient secondary mortgage market. In the 1990s, both agencies were given the task of expanding home ownership among those on lower incomes. This was in effect a mandate to enter the subprime market without taking on undue risks and while also returning a profit. The private sector competitors of Fannie Mae and Freddie Mac in the 1990s used low underwriting (risk-rating) standards to issue mortgages in the subprime market with a view to reselling them to Fannie Mae. For a time, around the turn of the millennium, the folly of this kind of lending was recognized, and the resulting mortgages were no longer allowed to be bought by Fannie Mae and count toward its targets for affordable loans. After 2004, this policy was reversed. Private mortgage issuers reverted to poor underwriting practice, attracting customers away from Fannie Mae and Freddie Mac.

Freddie Mac and Fannie Mae securitized the relatively low-risk mortgages they financed and also guaranteed the resulting securitized products. But, as we have already seen, privately generated, poorly underwritten securitized mortgages were now proliferating and being traded without the oversight of the big federal agencies. These mortgages were not designed to be repaid affordably over a term of thirty years. They were sometimes geared to quick resales and payments that only covered loan interest. In the case of the market leader in subprime mortgages, Countrywide, the holder of a mortgage
and his credit worthiness were secondary to whether a mortgage could be resold to banks as material for asset-based securities (FCIC, 105). In order to decelerate and reverse their loss of market share, Fannie Mae and Freddie Mac lowered their own underwriting standards. By the time house prices started to fall, they owned or guaranteed around half of the mortgages in the United States. With so many of these exposed to default, both agencies faced financial extinction. Despite being given access to government loans at very favorable rates, the share price of both companies fell around 90 percent between 2007 and 2008. In September of 2008, they were taken over by the U.S. government.

Coming finally to insurers, Table 1 highlights events in June and September 2008. In June, two monoline insurers had their credit ratings downgraded. Monoline insurers guarantee the repayment obligations of bond issuers. If the credit rating of the monoline insurers goes down, so does the credibility of their guarantees. The downgrading of MBIA and AMBAC was a sign of plummeting confidence in even supposedly low-risk issues of bonds. In the case of the huge insurer AIG, a credit downgrade greatly added to the collateral it had to offer in credit default swaps (CDSs) it had already committed itself to. CDSs were promises to pay on behalf of a bond issuer in case the bond issuer itself could not meet its debts. In September 2008, AIG did not have the cash to meet these obligations and had to be extended a federal government loan of $85 billion to avert bankruptcy, and a catastrophe for the many companies whose securities AIG had guaranteed. AIG had commitments to cover, among others, huge defaults arising from securities backed by collateralized debt obligations. Even though as an insurance company it was not part of the deposit-taking and mortgage-issuing and holding system that the U.S. government was legally responsible for, it was too big and too enmeshed with other important financial institutions—not only in the United States but globally—to be allowed to fail.

2. SEVEN FACTORS EMPHASIZED IN LEADING NARRATIVES OF THE CRISIS

So much for the events of the financial crisis, at least at its epicenter in New York. We come now to factors offered to explain the crisis as described. Seven general factors are represented in commentaries on the crisis⁴:

1. Low interest rates in the United States in the period leading up to the crisis encouraged a flight by investors to real estate and some financial derivatives. This factor is emphasized, for example, by Robert J. Shiller who draws on the idea that investor flight to U.S. real estate resulted

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in an bubble in housing prices, the bursting of which was the trigger for the crisis.\textsuperscript{5}

2. The securitization of such things as mortgage and credit card debt led to markets in financial products that were too hard to assess for risk. Securitization was the process of aggregating credit card and mortgage debt, including their repayment streams. Shares of these income-producing products would then be sold, the income varying with the risk rating of the underlying debt. Gary Gorton\textsuperscript{6} focuses on how these complex structures generated informational opacity with layers and layers of complex financial products built using mortgages and credit card debt as the foundation. When the housing bubble burst, it was the opacity of these structures that caused the broader contagion throughout the financial system, even though only about 2 percent of complex financial products of this kind were based on the problematic subprime mortgages.

3. The aggressive marketing of credit schemes to high-risk borrowers, and the quick selling on of securitized mortgage and credit card debt made it hard to detect large amounts of bad debt among large amounts of good debt. Indeed, it is an explanatory factor emphasized by Joseph Stiglitz\textsuperscript{7} as a central part of his polemic discussion of misaligned incentives, and by the likes of Akerlof and Shiller\textsuperscript{8} in their account of the mechanisms behind the crisis.

4. The deregulation of acquisition and merger activity by banks produced institutions whose failure threatened large-scale financial systems not just in the United States but globally. This is the problem of too-big-to-fail (TBTF) banks. Sometimes, it is formulated strategically: financial institutions in the United States that became very large through legalized acquisition and merger activity could count not just on their capital reserves to save them if things went wrong, but government bailouts. This encouraged them to keep reserves relatively low to invest recklessly with either customers’ money or borrowed money. This version is further part of the account of misaligned incentives offered by Stiglitz.\textsuperscript{9} Bank deregulation of a different form allowed “shadow-banking” to develop in the form of retail and commercial MMFs and the over-the-counter derivatives market, where the liquidity and debt of counterparties was almost always opaque. Gillian Tett, for example, invokes the now infamous failed attempt by

\begin{itemize}
\item 9. Stiglitz, \textit{Freefall}.
\end{itemize}
Brookesly Born, head of the Commodities Trading and Futures Commission in the United States, to have credit default swaps regulated, as a paradigm example of the importance of this factor.\textsuperscript{10}

5. Banks were able to use their influence with politicians to ensure their interests were favored. (This is sometimes called “regulatory capture.”) Bank influence is sometimes traced to partisan campaign contributions. Alternatively, it can be seen as the result of the accumulation of “intellectual capital,” or the widespread belief that Wall Street knew best, and that what was good for Wall Street was good for everyone. This is part of the story of the rise of a “financial oligarchy” presented by Johnson and Kwak.\textsuperscript{11} They are joined by Jeffrey Sachs\textsuperscript{12} in tracing this rise to an influential stream of political ideology in the United States and the United Kingdom that favored the withdrawal of the state as far as possible from the management of the economy, both from direct intervention via fiscal policy and indirect regulation of markets.

6. The politicization of the mortgage market in the United States contributed to the crisis of the two U.S. government mortgage agencies, Fannie Mae and Freddie Mac. Allegedly, a politician-driven policy of expanding home ownership among low-income groups increased the numbers of bad sub-prime mortgages, although there is still room for disagreement as to whether this policy was most clearly enacted through excessive government interference in the market or excessive deregulation.\textsuperscript{13} There is also disagreement on whether such policies were doomed to failure—credit was offered on unaffordable terms, but need this have been the case if government-supported real estate programs had been better targeted and administered?

7. Cash surpluses in foreign, including sovereign, investment funds stoked up the huge demand for the high-yielding investments, particularly in the United States in the early years of the millennium. Real estate debt was sought as an alternative to U.S. government debt, and the originate-to-distribute model for mortgage-backed assets catered for this demand. Indeed, according to Tony Dolphin, this trend can be traced back to the reaction of Asian economies to the Asian financial crash of the late 1990s, and the adoption of similar policies by China and oil exporting countries.\textsuperscript{14}


\textsuperscript{12} Jeffrey Sachs, \textit{The Price of Civilisation: Economics and Ethics after the Fall} (London: The Bodley Head, 2011).


All of these proposed causes of the financial crisis are mentioned in this collection. For example, Marco Meyer’s essay is a sustained examination of issues raised by (3). Meyer asks when, if ever, subprime borrowers ought to be lent money. The answer is not “never.” But neither is it “commonly and no questions asked.” The latter approach can be said with only a little exaggeration to have typified mortgage lending at the turn of the millennium in the United States.

The two most synoptic essays in this volume, by Tom Sorell and David Silver, mention all of (1–6), while also addressing the questions of who was responsible and how bad the crisis was morally. Sorell claims that people at the top of banks like Lehman Brothers were individually responsible alongside regulatory institutions and other public bodies. Rash and greedy or impatient individual investors and borrowers also contributed to the crisis, Sorell says, but they took the bad financial consequences often personally and directly, while many in investment banks survived the crisis wealthy and unpunished. Not only were those in charge of banks reckless; they damaged the Rawlsian social contract by subordinating the socially useful banking function of intermediation and deposit taking to speculative activity.

Silver’s claim is different. According to him, it was the “moral culture” of the financial services industry as a whole, not the actions or culture of individual banks, that gave rise to the crisis. This was a culture of imprudence, greed, arrogance, and other vices. The industry spent vast amounts of money to change U.S. legislation that protected against the effects of those vices, and then took money from the U.S. and other governments to prevent or stave off a total collapse of financial services.

Most other essays in the volume apply different theories of responsibility, especially theories of collective responsibility, to selected bank and investor behavior in the precrisis and immediate postcrisis periods. Peter French argues that individuals cannot be held responsible for the whole crisis even though they can be held responsible for individual acts of intentionally mis-selling financial products that were typical in the precrisis period. This involves him in reconsidering some of his earlier views on responsibility. Steven Scalet takes his starting point from the notion or organizational purpose and asks how that helps with the allocation of responsibility for the financial crisis.

James Dempsey, developing earlier work of his own,15 considers how the concept of culture, which we have already seen invoked by Silver, helps to allocate responsibility to many in banks, not just those at the top, during the financial crisis. Vilhjálmur Árnason and Salvör Nordal attempt to show that, vague as it is, Silver’s notion of moral culture does apply to Icelandic banking during the financial crisis.

Kendy Hess develops a notion of “collateral responsibility” that is not individualist, collectivist, or holist, and applies it to the activity of Countrywide, a mortgage originator that failed early in the crisis. Jeffrey Moriarty takes

James Dempsey and Tom Sorell

the financial incentives that were given to bankers to take risks. Should these have been kept under control by regulators alone? No, Moriarty says. Executives and bankers in financial services firms, respectively, offered and acted upon the incentives, and members of both groups are blameable on both counts. Catherine Greene considers the valuation of exotic financial assets and argues that legislation by itself will not address the associated risks. More is needed, in fact something like personal virtues, on the part of actors in finance.

Boudewijn De Bruin asks whether theories of individual and collective responsibility for complex events do justice to the financial crisis, any more than they do justice to climate change. In a sense, he says, no one was to blame for the financial crisis. In an article that sometimes seems to agree with De Bruin’s but in fact does not, Mark Hannam denies that bankers and banking should be blamed for the crisis, defending as reasonable at the time many of the investment and securitization practices that are routinely criticized by commentators. In fact, he says, the responsibility for the crisis is shared by all of us through our connection to democratic institutions that passed the laws that allowed banking to get out of control. Joseph Heath, too, is more charitable to the bankers and regulators than other critics. Mistakes were made, to be sure, but the proliferation of certain financial instruments—especially credit default swaps—could reasonably have been viewed as a kind of insurance against financial disarray, rather than, as they appear in hindsight to be, exacerbators of the liquidity problems that were the last straw in 2008.

Although the essays mainly focus on activity included in Table 1, two broaden the temporal and geographic perspective. Seumas Miller’s paper considers the manipulation of the interbank lending rate usually referred to as the “Libor scandal.” This gained prominence after 2008, though some manipulation may have occurred earlier. Miller applies his own theory of collective responsibility to the Libor scandal. Jens Van ‘t Klooster takes up some of the effects in Europe of the crisis, in particular lending to governments from the European Central Bank. These loans, like domestic bailouts in the United States and the United Kingdom, were widely regarded as improper, but van ‘t Klooster also considers their constitutionality, and the way they count as an “emergency” in the sense of something justifying the exceptional exercise of exceptional powers

3. TEN YEARS ON

What has happened since 2008? U.S. share prices as measured by the S&P 500 index have gone up hugely—from 850 on the index in November 2008 to over 2600 in April 2018. The U.K. stock market also boomed in 2017 and 2018. U.S. banks now have enormous numbers of employees—in some cases

16. Almost uniquely among the contributors—Greene is the other exception—Hannam has direct and sustained experience of high finance as an ex-banker in London. He has helped the editors of this volume meet many who were involved during the financial crisis in banks on both sides of the Atlantic.
about a sixth of their work force—collecting and analyzing data on their susceptibility to catastrophic losses. The international Basel 3 agreement has introduced voluntary requirements on the amounts of capital held by investment banks, and in particular “globally systemically important” banks. These measures have to some extent undone the addiction before 2008 to borrowed money for investment. In the United States and the United Kingdom, legislation has been introduced that insulates governments and taxpayers from the consequences of bank failure. Sometimes this has been accomplished (as in the United Kingdom) by decoupling the retail and investment operations of banks. In the United States (under the 2010 Dodd-Frank Act), the numerous regulatory agencies of the pre-2008 era have been consolidated and some speculative investment by banks restricted (the Volcker Rule). In addition, “predatory lending” such as operated in the subprime mortgage market of the early 2000s has been outlawed. Securitization of mortgages and other debt has been restricted. In short, many of the seven causes of the crisis listed earlier have been acknowledged and addressed.

It would be a mistake, however, to think that a new financial crisis is unthinkable or that the effects of the financial crisis are no longer being felt. Low interest rates since the crisis have spurred large amounts of personal borrowing and are perhaps creating conditions for a new subprime market. Donald Trump promised early on in his term as president to consider some deregulation of the banking sector, another slightly ominous form of backsliding. Although bank bailouts in the United States have been repaid with interest, the same is not true in the United Kingdom, and European bank share prices are still very far below their precrisis levels. The after effects of the financial crisis are still visible in big United Kingdom government budget deficits. Finally, Brexit is clouding the prospects for financial services in the United Kingdom and Europe after 2020. Whatever happens in the next ten years, it should not be anticipated with anything like complacency.17

17. The editors would like to acknowledge the support of the UK Arts and Humanities Research Council, Award AH/J001252/1.
Responsibility in the Financial Crisis
TOM SORELL

The global financial crisis began in 2007, and we are still feeling its effects. It involved the collapse or near-collapse of large commercial banks, hugely expensive interventions by governments to guarantee deposits and buy bank assets, a steep decline in bank lending to individuals and businesses, significant falls in consumer activity both domestic and international, and a resulting reduction in trade. Government indebtedness due to the crisis has resulted in diminished welfare states in Western Europe and a worsening of the position of the worst off in developed countries. In the United States, repossessions of properties rose very markedly after 2006, and members of both low- and middle-income groups have at times been very badly affected.

Two natural and related questions about the crisis are “What caused it?” and “Who, if anyone, is to blame?” Neither admits of a simple answer. The first is caught up with the difficulty of establishing an uncontroversial narrative of the crisis that is suitably related to data on previous, more local, financial crises.¹ The problem of a reliable narrative also affects the question of blame-

¹ The literature on financial crises identifies at least four distinct types, which in practice often overlap. The criteria for identifying an event as a crisis of a particular type are disputed, as are the explanations for how each occurs. Such uncertainty also creates challenges for identifying the real effects of crises. On these points, and their relation to analysis of the recent crisis, see Stijn Claessens and Ayhan Kose, “Financial Crises: Explanations, Types, and Implications,” IMF Working Paper WP/13/28, http://www.imf.org/external/pubs/cat/longres.aspx?sk=40283.0

DOI: 10.1111/misp.12081
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worthiness, which, in addition, is beset with philosophical complications. If people involved in the crisis are blameworthy, they have to have contributed in significant ways to the collapse of large commercial banks, the credit shortage, and so on. The scope for individual responsibility for such large-scale effects may at first appear to be slight. And although there have been journalistic attempts to identify guilty individuals, these assignments of blame are disputable.

Some people say that a bad “culture” grew up in banking in the years leading up to the crisis, and that this, more than individual action, or this rather than individual action, operated to create the crisis. Even if this view is wrong, and there are identifiable guilty, and therefore blameworthy, people, should we blame them? This question bears two senses, depending on whether blame is interpreted as an attitude or a public practice. Although there may be people who feel qualms about adopting even the attitude of indignation toward bankers or regulatory authorities, I will proceed as if this is unduly charitable or purist. More controversial may be a public practice of blaming bankers, say by imprisoning or fining some of them, or short of that, bringing them before parliamentary committees, demonstrating outside bank headquarters in the City of London or Wall Street, running press campaigns aimed at forcing resignations, or exchanging derogatory comments about individual bankers and bankers in general on social media.

Should bankers be blamed through public practices? Sometimes there can be good reasons for not publicly criticizing or punishing people who are responsible for wrongdoing. For example, it might make sense not to blame people who blame themselves already and who do what they can to put things right. Differently, it might make sense not to blame people who, though they were in charge when things went wrong, were as conscientious as anyone could be, but were ineffectual even so. Do any of these reasons for not blaming people apply to the banking crisis? No. Although some of the investigatory reports on the banks try to enter into patterns of financial thinking prior to 2007 in order to see whether decisions were unreasonable by standards prevailing at the time, this seems to ignore the fact that standards in 2007 were themselves a conscious departure from standards that in the recent memory of bankers were taken to be demanded by prudence. Nor was the financial crisis so big and so complex that the actions of individuals dwindle into insignificance. According to me, some individuals do stand out as reasonable targets of opprobrium, complex as the crisis is. This is because they occupied positions

2. For example, the UK Financial Services Authority’s report into the failure of the Royal Bank of Scotland accepted that the RBS management and board made poor decisions, but found that they were not sanctionable under law or the FSA rules because processes and controls were not clearly deficient, and the decisions were not outside the bounds of reasonableness, given the information available at the time. See Financial Services Authority, “The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report.” http://www.fsa.gov.uk/rbs. The U.S. government’s Financial Crisis Inquiry Commission likewise blames institutions more often than individuals. See Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (subsequently abbreviated FCIC) (Washington, DC: U.S. Government Printing Office, 2011.)
of leadership or authority in which they enjoyed considerable latitude to act and make far-reaching decisions. These people were not new to their positions when the crisis started, and their duties certainly extended to informing themselves about and judging the risks of activities that led to the crisis.

This is not to say that every piece of wrongdoing in the crisis can be apportioned to specific people: sometimes it may be plausible to speak of corporate failure—in the sense that there was a questionable consensus in an organization about what was permissible that no one person orchestrated or created. Again, regulatory failure is likely to be ascribed to institutions, unless there are special reasons to believe otherwise—for example, a history within the institution of general deference to some one person within it, or a management structure assigning great authority to a particular office within it. But the idea that, in general, the responsibility for the banking crisis can only be collective, or that it attaches itself to a noxious culture that insulates people from personal blame, seems to me to be wrong.

I shall outline a framework that permits responsibility in the crisis to be ascribed to individuals as well as institutions. This framework leans heavily on the idea that banks in general have distinctive public purposes, that roles in both banks and regulatory bodies are well enough defined to permit moral judgment of actions within these roles, that actions within these roles are supposed to be judged—by the public, designated insiders, and regulators—and that some decisions taken within these roles were highly damaging in the early 2000s. Size and connectedness also matter. Big banks whose fortunes affect a national banking system are spectacularly unsuitable sites for recklessness. A national banking system has some claim to belong to the Rawlsian basic structure of a liberal democratic jurisdiction, and “systemically important” banks affect the banking branch of the basic structure. If decisions made by ostensibly private actors in private banks can predictably unhinge the banking system, those ostensibly private decisions, private roles, and private institutions are strongly public-aspected, and carry special responsibilities that attach to individuals who lead banks. In a sense, executives of big, system-affecting banks play public roles, and not just after big banks have been bailed out by governments. Nor does personal responsibility in those roles make bankers answerable only to shareholders and regulators, since the safe-keeping of the banking system is bound up with the vital interests of a whole citizenry in developed countries.

The main events of the financial crisis (at least at its epicenter in the United States in 2007–2008) have been summarized in the Introduction to this volume. Complex as those events certainly were, they were not acts of God or the components of a natural disaster. Most, if not all, resulted from decisions within financial institutions and regulatory bodies, primarily in the United States. The U.S. Financial Crisis Inquiry Report makes a lengthy and well documented case for holding responsible the Federal Reserve and other
regulatory agencies in the U.S. financial sector. These agencies, the report shows, were given timely information about problems in the subprime market, including fraud and predatory lending, and were also aware of accounting problems in Fannie Mae and Freddie Mac that predated the events summarized in Table 1 of the Introduction.

The regulators either did nothing or too little. As for the private sector, many important risk-taking decisions directly related to the events in Table 1 can be traced to decisions by executives in banks, money market funds, and insurance companies. Some of these decisions seemed imprudent to dissenting senior insiders when they were made, and were even matters of dispute leading to resignation. It is not only in hindsight, then, and not only to outsiders, that these decisions seemed irrational. After discussing the case against the regulators, I shall go on to give examples of some of the decisions that arose within financial institutions. As will emerge, some of those decisions are naturally attributed to individuals within those institutions rather than the institutions themselves.

According to the U.S. Financial Crisis Inquiry, regulators had ample power in many arenas and they chose not to use it. To give just three examples: the Securities and Exchange Commission could have required more capital and halted risky practices at the big investment banks. It did not. The Federal Reserve Bank of New York and other regulators could have clamped down on Citigroup’s excesses in the run-up to the crisis. They did not. Policy makers and regulators could have stopped the runaway mortgage securitization train. They did not. In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee. (FCIC, p. xviii)

The Federal Reserve Board in Washington comes in for particular criticism, because at least one of the Fed governors, Ed Gramlich, was very sensitive to problems in the mortgage market as early as 2000 and voiced them in public, but apparently thought he could make no headway in the Fed Board more generally. The Fed’s leader—Alan Greenspan—believed deeply in the capacity of markets to regulate themselves. In 2002, bad mortgage lending practice had gotten out of control, partly because the institutions involved believed that securitization had the effect of spreading risk and also that supposedly low-risk tranches of securities really were low-risk. In fact, judgments of risk relied on credit rating agency models of risk that were very defective (FCIC, p. 28) and had been influenced by the banks themselves.

Problems with regulation went beyond failure to curtail high-risk lending. There was the fact that different financial institutions could choose between
federal and state supervision, and between recognized regulators at each juris-
dictional level. This created a kind of market in regulators in which the
more lenient were likely to be chosen by institutions legally required to have
oversight (FCIC, p. 20). Again, in the early 2000s, stringent state regulation
of predatory lending and other bad lending practices was judged to interfere
unlawfully with certain federal regulatory prerogatives, thereby undermining
some tightening up of lending that might otherwise have taken place. In this
way, the clash between state and federal governments and a competition
between them to grant bank charters aggravated the failings of what was
already an ineffective regulatory regime.

Within investment banks themselves, many decisions were made that
seemed questionable to insiders before and during the period covered by
Table 1 (see Introduction). A number of these decisions were directly relevant
to the failure of Lehman, which in turn arguably marked the high point of
the crisis. For example, some decisions made in 2008 within Lehman were
supposed to reverse declines in its share price after the collapse of Bear
Stearns. Lehman tried to reassure investment analysts who doubted that Lehman
was sound, and it also put pressure on regulators to outlaw “shorting” of its
shares. Regulators were unreceptive to the pressure, and the reassurance
offensive was also unsuccessful. At the heart of the failure of the latter was
the fact that Lehman assets—many of them mortgage-backed securities—were
overvalued, and that there was confusion even at high levels in the firm about
the accounting conventions used to communicate their values. “Mark to mar-
et” measures gave an up-to-date valuation, but Lehman used figures that
were only updated quarterly. This meant that the valuations were unduly
optimistic. The same optimism had affected declarations for investors and
regulators close to the time of the failure of Bear Stearns that Lehman had
a strong balance sheet, and that it was therefore not next in line to fail or
to seek a buyer for its distressed assets.

Long before Lehman reached crisis point, its chief executive officer,
Richard Fuld, and its president, Joseph Gregory, had backed heavy investment
in real estate—investment ranging from direct purchases of famous New York
office buildings and massive residential development projects on the Florida
and California coasts, to securitized mortgages. Fuld and Gregory had backed
the judgment of Lehman’s real estate director, Mark Walsh, who gained a
reputation for bold, high-risk deal-making. When the property market started
its decline, this aggressively developed line of business made its own
contribution to Lehman’s failure. Although the decision to concentrate

Economic Perspectives 29, no. 3 (2005):16–33.
4. Shorting or short-selling takes place when shares are borrowed from brokers and sold—in
the hope that they can be repurchased later at a lower price, and returned to the lender at a profit
to the short-seller.
5. For a vivid and detailed account of how these accounting unclarities led to a highly influential
recommendation by a hedge fund manager called David Einhorn to sell Lehman shares in May
2008, see Andrew Ross Sorkin, Too Big to Fail (London: Penguin, 2009), 100ff.
investment in real estate is not on its face a case of wrongdoing, it was arguably imprudent and to that extent a step on the way to the precarious position reached later by Lehman.

Many other examples can be given of bad decisions in organizations that have already figured in the summary of the crisis given in the Introduction. AIG’s decision to involve itself deeply in credit-default Swaps is one example. As has already been seen, this generated unsatisfiable collateral demands when Lehman was on the point of failing. Reserve Management made a bad decision to start to invest in mortgage-backed securities when it had previously invested only in U.S. government-issued securities. This was not a decision that seemed uncontentroversial at the time it was made, as it was the subject of a disagreement between the father and son who ran Reserve Management.6 The folly of these decisions was magnified by the holdings of both AIG and Reserve Management in Lehman. Further examples of imprudent commercial behavior can be found in organizations at one remove from Lehman. There were the disproportionately real estate–focused strategies of both Merrill Lynch and Citigroup, allied to their policies of borrowing huge amounts over a long period to finance investments.

The decisions underlying the strategies of the Wall Street institutions we have mentioned do not only appear questionable to people looking back, or from vantage points outside these businesses and their culture. In the case of Lehman particularly, there were many insiders who openly expressed doubts about Gregory’s management of the business and Fuld’s loyalty to him.7 And Fuld’s policy of trying to win over external critics of the business to protect its share price exposed him directly to their very substantial grounds for doubt about the strength of Lehman’s balance sheet. The question of whether these weaknesses—rather than purely speculative shorting—might be at the source of the decline in the Lehman share price does not appear to have been taken seriously by Fuld until it was too late.

II

We are now in a position to return to the question raised at the beginning: can blame be directed at individuals and institutions in the crisis, and ought it to be? That institutions bear some of the responsibility seems not to be in doubt. The Fed on one hand, and, on the other, a host of financial institutions, all appear to have failed to judge the various risks involved. Sometimes these misjudgments appear to have arisen through misinformation within organizations—as in Citigroup—and sometimes through critically weak accounting methods. In the case of the regulators, the failure seems partly to have arisen from a dogmatic attachment to *laissez-faire* in the financial markets. Another contributing factor may have been successful lobbying by the banking sector.

7. Sorkin, 124ff.
Institutional responsibility cannot be the whole story, however, because even competing narratives of the financial crisis agree that many poorly judged policies had identifiable and powerful individual backers or originators high up in some of the different institutions involved. These were no mere bystanders or more or less equal players in a big team effort. Rather, they initiated or gave backing to policies that went wrong; they overruled dissenters lower in the hierarchy; and they sought to placate rather than to listen to big investors and financial journalists who put their fingers on the genuine problems: notably, too much investment with borrowed money, and too much exposure to real estate and real estate–backed securities.

Richard Fuld of Lehman and Sanford Weill of Citicorp presided over very protracted periods at large financial institutions; Stan O’Neall, who led Merrill for a relatively short period, fired thousands of employees and replaced many of its top executives, as well as beginning the policy of highly leveraged investment and concentration on securitized real estate products. He was not single-handedly responsible for all the trouble Merrill got into, but neither was he merely one among many agents whose respective small actions added up to the cause of the firm’s problems. On the contrary, his actions were bigger than those of other people in Merrill, and even though the crisis did not reach its peak while he was in charge, the actions he took when he was in a leading role contributed to Merrill’s weakness when the crisis came. The same, for reasons already explained, is true of Fuld, and others.

These facts have a bearing on explanations of the crisis that invoke collective responsibility. Although corporations have the kind of unity and organization and deliberative powers that seem to permit ascriptions of responsibility to them and not just to the individuals who work for them, it does not follow that, when institutions are responsible, they are responsible to the exclusion of individual responsibility. On the contrary, in corporations where top executives are given considerable discretion to plan, hire, fire, and invest, both the organization and individuals at the top can be appropriately praised or blamed.

Not that people at the top of financial institutions or regulatory authorities are solely to blame in the financial crisis. Some people at the bottom of the heap—some with very low incomes who knew that they would not be able to repay big loans, but who took them on anyway—those people, too are blameworthy. So are people in the middle who overborrowed for no better reason that they were keen to make money out of rising house prices or were impatient to finance consumption that could have waited. Still, there is a difference between the irresponsible person at the bottom of the heap and those at the top. The ones at the bottom took the consequences of their imprudence by losing the roof over their heads and their access to credit. Even the disadvantaged who did not borrow irresponsibly suffered. This is because the public money that has been used to repair the damage to the financial system has depleted the resources available for the welfare state. In this way the

8. Sorkin. 143ff.
imprudent subprime borrower on a low income has been punished consider-
ably more severely by the financial crisis than even quite irresponsible bank
executives. The imprudent subprime borrower has been punished not only with
repossession and sometimes personal bankruptcy but also by a thinning of the
public safety net that they have come to need more since 2007.

By contrast, many of those at the top of banks that failed have suffered
little more than public disapproval and the loss of jobs they did not need in
order to live comfortably or better. Top bankers who were fired have remained
extremely wealthy. It got much worse for the disadvantaged, but imprudent lead-
ing bankers have suffered very little or not at all. Not only have many of them
continued to live in luxury, but, as individuals, they also have suffered less and
less vilification the more the events summarized in Table 1 have receded into the
past.

The condition of the bankers contrasts with that of many other groups
of people, even if we disregard those who are most reliant on the welfare
state. Among the relatively well off who have reason to resent the bankers
are middle-class people whose pensions and other investments lost much of
their value through no imprudence of their own; managers and employees
in sound small businesses who are affected by the continuing credit short-
age; and unemployed but well educated young people whose prospects were
worsened by a very long-lasting economic recession in the whole of the
developed world. These people, when combined with the worst off, may not
add up to 99 percent of the population, as the Occupy movement claims.
But they are numerous and have been significantly harmed by the financial
crisis.

III

What theoretical understanding of responsibility enables us to make sense of
the intuition that leading bankers have been unduly insulated from the conse-
quences of their decisions? I shall make use of a framework that was developed
to discuss the apparent insulation of public officials from blame for actions
done within their official roles. It may seem that this framework is inappro-
priate for the responsibility of bankers, since bank executives are not public offi-
cials. I shall argue, however, that the framework fits after all, because of the
way that the actions of big-bank officials in the early 2000s affected the banking
system, and because of the way bank officials sought to sidestep or dismantle
regulation that was a key component of that system, and that was partly mor-
ally motivated. The banking system has a special public status that executives
in the biggest banks, through their ostensibly private sector roles, are sometimes
in a particularly good position to damage. The fact that bank executives in the
crisis, sometimes self-consciously, acted to change regulation of the system self-
interestedly, gives their actions a public dimension. Differently, the fact that
some leaders of big banks knew that their banks were systemically linked to
other banks through elaborate counterparty arrangements, sometimes involving
very large amounts of debt, makes it plausible to say that they were aware of
their banks’ systemically important status and yet did little or nothing to reduce
the risk taking that exposed not only their banks but also the banking system
to crisis. In particular, they are open to the criticism of acting unjustly, and
not just of making poor or disastrous business decisions.

In order to spell out this line of thought, we need to distinguish big
from small banks, banks from the banking system, and also banks from other
kinds of big business. The banking system in a capitalist economy is supposed
to make savings available for productive investment. It is supposed to do this
for both individual and commercial borrowers. This intermediation between
investors and savers is supposed to occur without loss to savers, and indeed
with a return to savers as well as banks. This is supposed to be accomplished
by the differential between interest rates charged to borrowers and interest
rates offered to savers. Since the class of savers in a developed country can
include most of its population, there is a significant overlap between the class
of savers and the class of citizens. Again, since a system for holding savings
securely is likely to be a precondition of accumulating wealth, and of systematic
economic exchange, commercial retail, and wholesale banking—not just central
banking—has a claim to be politico-economically fundamental. This distinguishes
the banking sector from other business sectors. Furthermore, since personal
wealth is both a Rawlsian primary good and an important component of per-
sonal welfare, the banking system has a good claim to belong to the Rawlsian
basic structure—that is, to belong to the set of institutions involved in the
distribution of goods that are available for the realization of Rawlsian life
plans.

The banking system is not just the total number of banks interacting
with one another and with savings and borrowers, but this together with the
relevant regulatory institutions and their enabling and other legislation. In the
United States, the regulatory institutions include, as we have seen, the Federal
Reserve system at both the national and regional levels, and state regulators.
A particularly important piece of legislation for the banking sector before
the period immediately leading up to the crisis was the Glass-Steagall Act,
which was introduced at the time of the Great Depression, and was super-
seded in 1999. This Act prohibited U.S. banks of an earlier era from engaging
in several of the banking strategies that contributed to the current crisis. These include the following:

1. The development of products—offered in the 2000s through money mar-
ket funds—that simulate retail bank without being subject to the capital
requirements and accounting rules of retail banks;
2. Significant borrowing by banks from other banks, large companies, and
sovereign wealth funds to finance investments; and
3. Significant merger and acquisition activity involving retail banks on the
one hand and insurance companies and investment dealers on the other.

Not all major banks participated equally in these developments in the decade
after 1999. In particular, JPMorgan Chase was considerably less leveraged
Responsibility in the Financial Crisis

than its competitors, and less exposed to real estate. But many major banks that have already been mentioned in our narrative were party to these changes, which together had the effect of weakening the U.S. banking system and not just individual banks.

Because the Glass-Steagall Act was in force for such a long time, there is a sense in which it defined the culture of pre-1999 banking in the United States. Against the background of the Great Depression, the act sought to eliminate lending for speculative investment, and it imposed capital requirements on banks designed to make them able to resist runs. It encouraged lending for “commercial” as opposed to “speculative” investment, and it limited interest rates for savers while insuring their savings up to certain limits. The Wall Street banks collectively, through lobbyists, were important undoers of Glass-Steagall. They supported the Bank Modernization Act. This relaxed or abolished prohibitions on links between commercial and speculative banking. Individual Wall Street banks also lobbied for the relaxation of laws restricting predatory lending as well as bankruptcy.

Not only banks corporately but also individual bankers pressed for deregulation. Foremost among these was Sanford Weill of Citigroup, who was personally involved in the negotiations between the White House and Congress that led to the Bank Modernization Act. It was Weill who hung up in his office a large piece of wood inscribed with his portrait and the legend, “Shatterer of Glass-Steagall.”

The Bank Modernization Act of 1999 legalized acquisitions and mergers between retail deposit takers, investment banks, and insurance companies. Citigroup was associated with the takeover of Traveler’s Insurance before such a takeover was legal. It is hard not to conclude that the Bank Modernization Act, whatever else it may have had to recommend it, was backed by Weill partly because it made possible the creation at Citigroup of a single institution offering the whole spectrum of financial services.

9. Its strength put it almost uniquely into a position to rescue another major financial institution, as it did in the government-assisted rescue of Bear Stearns. Very recently it, too, has been revealed to be involved in the kind of high-risk and highly speculative investments that it prudently avoided at the height of the crisis. Its huge losses in the so-called “London Whale” affair have damaged its reputation at a time when many other tainted banks seem to have begun the return to solvency and profit. See http://www.huffingtonpost.com/2013/04/11/dimon-london-whaleapology_n_3060811.html


11. On the other side, it also permitted a choice for banks between federal and state regulation, a permission that we have seen encumbered measures against predatory lending in the early 2000s.


14. The abolition of Glass-Steagall has been proposed as one of the causes of the crisis. See http://mises.org/daily/3098
The influence of at least one banker and many banks on relaxing the rules for the commercial operations of banks; doubtful leveraging policies originating at the top of bank management hierarchies: an over-concentration on assets in or backed by real estate also as a matter of the policies of top bankers: all of these things contribute to an explanation of why individual bankers are appropriate objects of blame after the crisis; and, in particular, why they are appropriately objects of more severe public blame than has actually been directed at them. On one hand, they are guilty of a morally objectionable regulatory capture—not just an economically objectionable regulatory capture—that is, one that carries inefficiencies; on the other hand, they are guilty of a kind of imprudence—consisting of high-risk borrowing and lending—that would be considered the height of recklessness in private life, and that is particularly reckless when engaged in through executive decision making within a bank, given that banks are custodians of other people’s money, and operate in a legal regime where keeping that money safe is a leading legal requirement.

In order to theorize the injustice of regulatory capture more precisely, we need some apparatus from John Rawls, and in order to theorize personal responsibility for both regulatory capture and high level decision making within banks, we need some apparatus related to Rawls from Thomas Nagel. I come to Nagel later.

The apparatus we need from Rawls is the idea of “basic structure” or the set of institutions crucial to a correctly principled distribution of Rawlsian primary goods. The institutions certainly include courts and legislatures, and also the family. Institutions for regulating the monetary supply and interest rates also seem to be included. But media organizations seem not to belong to the basic structure. They belong to a distinctively pervasive “background culture,” which also includes universities and “associations of all kinds.”

The idea of the basic structure has been criticized for obscurity and possible incoherence by G. A. Cohen, and I take advantage in my exposition of some of the clarification that this criticism has provoked from defenders of Rawls. In particular, I take over from Andrew Williams the following: (1) that the basic structure is realized by institutions that belong to the “informal structure” of society, and not just the set of coercive institutions;


17. See *Theory of Justice*, 273: “In conformity with political decision reached democratically, the government regulates the economic climate by adjusting certain elements under its control, such as the overall level of investment, the rate of interest, and the quantity of money, and so on. There is no need for comprehensive direct planning. Individual households and firms are free to make their decisions independently, subject to the general conditions of the economy.”


(2) that the relevant institutions respectively operate by different sets of “public” rules; and (3) that social justice is a matter of selecting that combination of coercive and other informal institutions that secure basic liberties, fair equality of opportunity, and the maximinization of income and wealth.20

Now banks seem to belong to the basic structure of a society not because they are coercive but because they, or at least the banking system, belong to the wider “informal” social and economic structure. Again, the banking system seems to belong to the basic structure in respect of its “dispositional” property of having pervasive effects,21 especially in relation to the maximinization of income and wealth. We have already seen how, when it is in crisis, it can worsen the disadvantage of those at the bottom. But there are also ways in which it can temporarily advantage the worse off—represented in our narrative in the Introduction by subprime borrowers—while eventually disabling coercive basic structure institutions for effecting transfers that would maximinize. Then there are the trade-offs involved in keeping the banking system in equilibrium à la Glass-Steagall in normal times: in return for capitalization requirements and ceilings on interest rates that retail banks can offer depositors, there is deposit insurance guaranteed by central government that prevents runs and the loss of large amounts of savings. Competition between savings banks through unregulated interest rate offers for depositors, and in the absence of deposit insurance, left many people penniless in the Depression. Relatedly, buyers of units in money market funds incurred losses when those funds suffered “runs.”

Maximinization apart, there is the role of banks in traditional intermediation, that is, in the prudent transformation of savings into investment. It is hard to think of a more fundamental function of the economic system for both individuals (through mortgages) and (through “commercial investment” in the Glass-Steagall sense) for what Rawls calls “associations,” including commercial associations, that is, businesses. Of course banks may also have other economically useful commercial functions, such as being sources of sophisticated acquisition and merger strategy for big businesses, and of methods of financing that extend well beyond conventional loans of deposits. Banks are active in the “repo” market, for example. In the period leading up to the crisis, the tendency of banks to be involved in all kinds of intermediation, as well as more risky proprietary trading, made them more embedded in the informal basic structure than they might otherwise have been and more of a burden on the formal basic structure, including its legally backed bank regulatory and central banking institutions, when things went wrong.

The role of the banking system and the “systemically important banks” within the basic structure is part of what connects the actions of certain highly placed bankers in big banks with injustice. But what about the personal responsibility, if any, of particular people within these institutions? A


21. Williams, 231.
framework that helps to organize our thoughts in this area can be adapted from Thomas Nagel’s “Ruthlessness in Public Life.”22 Nagel sets out to show that public office does not insulate officeholders from personal responsibility for wrongdoing committed through their offices. Thus, according to Nagel, Robert McNamara was personally (though not solely) responsible for what Nagel considers to be criminal U.S. military policy implemented during the Vietnam War. He was personally responsible notwithstanding the fact that he was pursuing public ends in a war. According to Nagel, public office does not free office holders from the obligations of ordinary private morality, but the purposes of public offices make results (as opposed to means) count more than they do in private life, and the means of accomplishing these purposes legitimately include powers that would not normally be available for the pursuit of private purposes. These unusual powers may not be used in any way an officeholder likes: law and impartial courts are supposed to constrain office holders. This explains why, for example, shows of partiality or favoritism may be strictly outlawed in public life though they are permissible in private.

The heightened power of public office derives from the public purposes of the office. These public purposes are to bring certain publicly recognized benefits to groups, including nations. Despite the greater latitude given to office holders to pursue such goals as public defense and wealth redistribution through means—notably coercion—that are not open to individuals pursuing their personal goals, it is not permissible for public officials to pursue public goals by whatever means they choose. Avoidable harm and disproportionate mass killing are always impermissible in public office and private life alike; for example, which is why McNamara's acting as Secretary of Defense does not get him off the hook if a military policy leads to a massacre or the targeting of the harmless. In the same way, the fact that any number of bank executives were pursuing a legitimate goal—bank profitability—and facilitating economic growth when they made a policy of reckless leveraging, does not mean that the leveraging was justified after all. Although it is part of the role of chief executive to pursue profitability, it is not part of that role to pursue profitability by high-risk means, and the reasons for avoiding unnecessarily high risk apply in both private and public morality.

In McNamara’s case, the public role of Secretary of Defense did not so to speak drown out the contribution of McNamara the man to the execution of defense policy. On the contrary, as Nagel very plausibly claims, the exercise of power through public office can be and often is a means of personal self-expression. Although there are certain effects that any Secretary of Defense tries to bring about, it is permissible to put one’s own personal stamp on one’s execution of the role, and the possibility of being regarded personally as one of the great presidents or prime ministers is no doubt one of the biggest attractions of those offices. It seems to be similar for leaders.

of big businesses. A successor to Steve Jobs who keeps Apple in profit may for all that live in Steve Jobs’s shadow, and other personalities have bigger profiles than even the high-profile companies they lead: Rupert Murdoch and Jeff Bezos might be examples. In the same way, certain banks that were prominent in the financial crisis were themselves run by high-profile executives who put their stamp on their companies. In this respect, personal involvement seems to be as much a feature of leadership in a role in big business as it is in government service.

Now the role of bank chief executive is not necessarily a public role in the way that U.S. Secretary of Defense is: it is not an appointment subject to legislators’ vetting of a person’s suitability for it, and the interests the post is designed to serve are not primarily those of the public or even the banking sector in general. Nevertheless, it has a strong public aspect if decisions made within that role significantly affect the survival of the bank, and the role holder knows that his bank is connected to the banking system in such a way that his bank’s failure or some decision of his bank would trigger significant disruption to the whole banking system. In 2008, in New York, the role of chief executive in Lehman, in AIG, in Bear Stearns, and in Citigroup had this strong public aspect. For short periods, the fate of a single bank seemed to determine that of the banking system, and so the commercial obligation of negotiating a rescue became not just a managerial responsibility but a matter of public obligation, too.

The form this took in the United States was that of an obligation to co-operate with the Fed and the U.S. Treasury—agents that were associated with coercive power—for the sake of the survival of the banking system. Sometimes the co-operation required one bank to acquire another; at other times it required a bank to accept government-dictated terms in return for grants and guarantees required for its own survival, and, indirectly, the survival of the banking system. In certain cases, the government’s terms proved questionable, because they were particularly advantageous for commercial “rescuers” and because they were influenced by considerations of party-political damage as much as by the survival of the banking system. For example, when JPMorgan took over Bear Stearns, it was initially willing to offer $4 per share, which meant a huge loss for Bear Stearns shareholders. The Treasury Secretary, Hank Paulson, suggested an even lower offer of $2 per share, so as to dispel the impression that the government-assisted rescue by JPMorgan was in any way bailing out Bear Stearns. Since that was exactly the impression that the rescue of Bear Stearns created, the main beneficiary of the Paulson-dictated share price was JPMorgan.

23. The term “systemically important bank” has only been added very recently to regulatory instruments in the United States, the United Kingdom, and globally. For one of the most recent pieces of international guidance, see Bank for International Settlements, “Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement” (July, 2013), https://www.bis.org/publ/bcbs255.htm

24. In the United Kingdom, similar obligations fell upon executives in Lloyds, RBS, and Northern Rock.

More objectionable than the advantageous terms offered to some banks at the height of the crisis was the effect of bank lobbying on banking law before the crisis. Banks were able to influence in their favor the legal regime governing their operations. This widened the area of the legally permissible in ways that Nagel’s model of the constraints on public office holding does not anticipate. Nagel’s model treats public offices and associated institutions as in turn constrained by further independent institutions, including judicial and legislative institutions, subject to strong norms of impartiality allied to serving the public interest. By being able to lobby for legislative change that was friendlier to the business plans of investment banks and mortgage originators, or combined investment bank/mortgage originators, the banks, both collectively and individually, brought it about that banking legislation did not realize strictly public purposes, but rather the purposes of the banking sector. And some figures in leading positions in the biggest banks were personally responsible for this regulatory capture, as Sanford Weill’s wall decoration proclaimed. Regulatory capture reduces the claim of an office with a strong public aspect to insulate its holders from responsibility for what is done through that office. In this way, individual bankers may be more guilty than McNamara, though of wrongdoing that is less than lethal.

IV

The upshot of the position being argued for in this article may appear to be close to that of some journalistic pilloryings of the bankers, such as *Time* Magazine’s “25 People to Blame for the Financial Crisis.” It is true that some of the people already mentioned figure in *Time*’s list. Sanford Weill and Richard Fuld do; so does Alan Greenspan. I agree that these people have personal responsibility (though of course not sole responsibility) for elements of the financial crisis. But there are important points of difference between the approach behind the *Time* list and my own, which accounts for some disagreements between a list that would be suggested by this article and the list suggested by *Time*.

*Time* sometimes chooses an individual to personify a regulatory institution or bank. So, for example, Chris Cox is high on its list of blameworthy people, because he was in charge of the Securities and Exchange Commission (SEC) at the time of the crisis, and it was within the power of the SEC to require more prudent leveraging from the banks. In this case my approach would be to ask whether in fact Chris Cox was the SEC in any important sense. The more powerful and long-lived the leader, the more the leader’s strategy is the bank’s or regulatory institution’s strategy, then the more personification makes sense. But it does not follow from the fact that someone is in charge that they are the organization in any interesting sense. So I am

26. See http://www.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877339,00.html
not sure that on my approach Cox is important to mention. (The SEC already has been mentioned.) Distinctions can also be made between bankers on *Time*’s list. In particular, Stan O’Neall was not related to Merrill as either Richard Fuld or Sanford Weill were related to Lehman or Citigroup, respectively. The latter two do have some claim to have personified the organizations they led. In the case of O’Neall, that is not so. So while all three bear personal responsibility on my account as well as *Time*’s, O’Neall has a weaker claim to be on the list, or a claim to be on the list different from Fuld and Weill, because he did not personify Merrill.

An important problem for *Time*’s approach emerges when one comes to the “person” listed fifth in its register of the blameworthy. This turns out to be no individual at all but rather “American consumers.” Why this group counts for only one in the list of twenty-five is unclear. Surely, it ought to expand the number on the list from twenty-five into the hundreds of millions. In any case, here is what *Time* says about this class of guilty people:

In the third quarter of 2008, Americans began saving more and spending less. Hurrah! That only took 40 years to happen. We’ve been borrowing, borrowing, borrowing—living off and believing in the wealth effect, first in stocks, which ended badly, then in real estate, which has ended even worse. Now we’re out of bubbles. We have a lot less wealth—and a lot more effect. Household debt in the U.S.—the money we owe as individuals—zoomed to more than 130 percent of income in 2007, up from about 60 percent in 1982. We enjoyed living beyond our means—no wonder we wanted to believe it would never end.27

My account has also mentioned individual borrowers who knowingly speculated on the property market rather than invested in a place to live, and those who would not defer consumption until it was within their means. But these people do not add up to the class of American consumers, even if most Americans or many Americans are in debt and do not save enough. Again, many of the people who speculated and who should have deferred consumption do not, on my account, deserve public blame. Many of them personally suffered the consequences of their imprudence—through personal bankruptcy or repossession of their houses. Public blame *in addition* is unnecessary.

My account has focused on those whose actions were much more far-reaching, whose imprudence was much more damaging than that of the small-scale property speculator, and who have not had to cope with much more unpleasantness as a result than being included in a list like *Time*’s. These people have gotten off unduly lightly, on my account. Still, the number of people in the group of well off and seriously damaging agents is probably not very large. It is certainly much smaller than the class of American banking executives, smaller even than the class of American executives in companies

27. See [http://www.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877319,00.html](http://www.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877319,00.html)
as central to the crisis as Countrywide or Citigroup, for even in those organizations there were people in powerful roles who could see big risks and who tried and failed to get things done differently. My account is geared to what I called the *strong public aspect* of decisions in banks that were able to affect the whole banking system. My account directs serious blame at relatively few people, people whose roles—I hope to have shown—are inevitably strongly publicly aspected ones, even though they are discharged in the private sector.
Some Tranching of Moral Responsibility Ascriptions to Individuals in Shadow Banking during the Financial Crisis

PETER A. FRENCH

1. TO TRANCHE—TO CUT INTO SLICES, TO DIVIDE INTO PARTS

Producing a coherent account of the causes of the worldwide Financial Crisis of the first decade of the twenty-first century is far beyond my skill set. The term “Financial Crisis” covers a spectrum of financial and economic events that spanned a number of years during that decade and had roots in the previous decade, if not earlier. It is an umbrella term, and the boundaries of its extension are somewhat blurry. It covers a collection of outcomes of a number of actions and inactions by a variety of entities and individuals that conjoined to create a “perfect economic storm.” It is not even settled when it began. Writers identify various starting points such as the peak of the housing bubble in the United States in the summer of 2006 or the “liquidity crunch” in the shadow banking system in late 2007, or the Lehman Brothers bankruptcy, or the “breaking of the buck” in the money markets in 2008. Unarguably, many of the dominant players that provoked and aggravated the crisis were in the shadow banking system¹ and the financial oligarchy’s offices on Wall Street in the United States, although there were myriads of additional institutional and individual players from the public and private sectors, in the

mortgage, insurance, and related industries, and in regulative agencies and elected and appointed governmental positions.

The shadow banks are those elements of the global financial system that are not under the direct control of regulators, including the unregulated activities of otherwise regulated banking institutions, allowing them a wider range of operations than traditional depository banks, including credit intermediation. The shadow banking system also encompasses hedge fund operations, broker-dealers that fund their assets using repurchase agreements, money market mutual funds that purchase commercial paper or mortgage-backed securities, and financial entities that take credit and liquidity risks in the commercial paper, derivatives, and other markets while lacking the capital proportionate with those risks.

The shadow banks were a primary focal point of much of the political and economic analyses of and the public animadversion for the near total collapse of the worldwide economic system in 2008. Those who are knowledgeable about such matters, however, view the debacle as the result of a complex, concerted, and serendipitous series of actions, inactions, and other influencing factors (including corporate cultures and political climates) among a very diverse collection of interrelated entities, not just shadow banks; and that those entities (individual, corporate, collective, and governmental) leading up to the crisis generally behaved in ways that, over the past two or more decades, were not especially uncharacteristic for most of them. Because the shadow banks, among a panoply of financial innovations and products, packaged mortgage loans to back short-term securities sold to investors with the value of the security coupled to the value of the mortgage loans in the package and the interest on the security paid from payments homeowners made on their mortgage loans, especially hard hit when investors questioned the real worth of the assets backing those mortgages were people who took out inflated mortgages on houses at alluring subprime rates. The mortgagees became unwitting (in large measure), yet crucial, and willing (because of the enticements they were offered) participants in the larger economic calamity: the ordinary folks on Maple Street were lured into complicity with the sharks on Wall Street. The monsters that were due on Maple Street turned out to be virtually everyone, and, as in the famous *Twilight Zone* episode, panic was the result.2

Characterizing the moral responsibilities of those involved in shadow banking during the Financial Crisis should expose a spectrum of ways in which individuals can become appropriate targets of blaming expressions. I recall that J. L. Austin said, “it is not enough to show how clever we are by showing how obscure everything is.”3 With that in mind, my aim is to try to illuminate a few ways in which moral responsibility for aspects of the crisis can be attributed to shadow bankers by first trying to clarify for what members of the moral community can be responsible and then sorting out ways in which

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moral responsibility for collective actions and events distribute among those in a collective, in this case those functioning in the shadow banking system.

For an entity to be a member of the moral community and susceptible to moral responsibility appraisals for what it does, it must be normatively competent. Minimally that means that it must possess internal mechanisms with the functional capacity to appreciate moral reasons as relevant to its act choices, the ability to react to those reasons with intentional actions and thereby acknowledge ownership of actions, and the facility to participate in moral dialogue and address. That is, members of the moral community must be “moderate moral reasons–responsive.”

Although humans are the prototypical members of the moral community, they do not uniquely possess the functional capacities required for normative competence. Two types of mechanisms can be moderate moral reasons–responsive: neuro psychological mechanisms in humans and organizational mechanisms in corporations or corporate-like institutions or organizations. Most adult humans and some corporations are self-referential and act from internal mechanisms that can recognize a sufficient moral reason not to do what they are about to do, and conceivably react to that reason, even if, in the circumstances, that is a rather remote possibility, and they can care about the moral quality of their actions, that is, they are affective. Whether or not an entity is normatively competent is a fact about the internal mechanisms or motivational structures that generate its action decisions and actions.

A second point of clarification: Gary Watson, in a well-known paper, distinguishes between the attributability aspect of responsibility and the accountability aspect. Watson, T. M. Scanlon, and Angela Smith among others opt for the attributability aspect, maintaining that justifiably holding an entity responsible is dependent on whether the event that occasioned the ascription is expressive of the entity’s inner structure with respect to value. On the other hand, Marina Oshana maintains that the appropriate way to think


8. T. M. Scanlon, What We Owe to Each Other (Cambridge, MA: Harvard University Press, 1998).


about holding responsible is to explicate the notion in terms of accountability. For something to be held to account it must be capable of entering into moral conversation, defend itself, make excuses, confess, justify its behavior, and so on. I cannot think of a reason why entities that can be held to account cannot also be attributably morally responsible. An entity, following Watson, is attributably morally responsible for an event if the occurrence of the event discloses something positive or negative about the nature of the entity, its structure, and its functionalities. If a responsibility ascription is negative on an attributability account, it is making the claim that its target is morally defective in some way. It is an assessment of the entity’s internal action mechanisms as measured against a relevant normative standard. If the entity identified as responsible for X is an individual human, the speaker is saying something about the quality of that human’s will as revealed by its intentional actions; if it is a corporate entity or institution, the speaker is saying something about its organizational mechanism and decision structure; and if it is a system the speaker is saying something about how its rules and practices do or do not align with a concept like justice. For example, the statement “The shadow banking system is morally responsible for the collapse of the repo market” expresses the speaker’s belief that there is a morally significant internal flaw in shadow banking that is revealed by the collapse of the repo market. The speaker, of course, would be expected to elaborate on what that flaw is and how it causally connects to the calamity in repo. Thus, the door is opened to discussion and debate among economists and finance experts as to whether such an internal flaw exists in the system or whether the debacle in repo was the product of those working in the system in a way that violated its established structural elements. If that is the case, then the focus of responsibility ascription shifts from the system to individuals and corporate entities.

It is widely acknowledged that the worldwide economic calamity to which “The Financial Crisis” refers was unexpected by virtually all of those whose actions brought it about. With respect to the internal neuro psychological states of the humans and the organizational decision structures of the corporate institutions (the firms) that played leading roles in it, the crisis was an externality, a resultant, but not an intended, consequence of their actions. Are individuals morally responsible for events, including super-events like the Financial Crisis, that are external to their internal springs of action? I think not, and not just because they lack control over their occurrence. What is essential in attributing moral responsibility to individuals (and corporate entities) is what is internal to them, specifically their volitions or willings. Consequently, none of the individuals whose actions precipitated, exacerbated, and prolonged it can be morally responsible qua individuals for the Financial

11. Three economists were identified in a piece in “Wall Street Economists” as having correctly predicted certain aspects of the crisis. They are Dean Baker, Med Jones, and Peter Schiff. Jones seems to have got more things right than the other two. www.economicpredictions.org/who-predicted-the-financial-crisis.htm.
Crisis per se. The Financial Crisis was a cumulative multifaceted result of many actions and events for most of which moral responsibility may be attributable to a number of humans, corporations, collectives, and possibly the shadow banking system itself. Instructively, we can imagine that the Financial Crisis (understood as the “perfect storm” event) never occurs while holding fixed the internal states of the various entities and their actions that were integral in bringing it about, and its nonoccurrence will not alter (lessen) the moral responsibility attributable to each of them for what they did as shadow bankers. The Financial Crisis’s occurrence, even if an inevitable result of their cumulative actions, does not increase their moral responsibility for what they did. Nor does its calamitous proportions, that are difficult for even the most highly trained economists to comprehend, provide a reason to reduce the moral responsibility of those entities for which contributing to the Financial Crisis (the super-event) was the unintended and unexpected consequence of their actions.

Individuals generally are responsible for their actions that under some true description were intended by them, but the consequences of those actions are not their actions. They are externalities unless a description of them legitimately can be fitted into the scope of individual’s intention in acting. Andrew Khoury offers the example of a man who shoots a child for malicious reasons. He maintains that the consequence that the child died because it is an external fact is not something for which the man is morally responsible. What the man is morally responsible for, he argues, is his trying to kill a child for malicious reasons. As Khoury puts it, “In order for a given consequence to result from some action the world must cooperate in some way and this is a matter external to the agent.” If an agent was responsible for the consequences of his or her or its actions, then luck would govern responsibility. In Khoury’s example, the man is morally responsible to the same degree whether or not the child dies. He is not less blameworthy if the child somehow survives. He is a malicious person who shoots children with the intent of killing them. There is not much worse than that!

My first response to Khoury was that his position is counterintuitive. Surely the fact that the child died is something for which the man is morally responsible and in criminal law the death of the child is a crucial fact in the determination of charges. If the child doesn’t die, the man cannot be tried for murder. But moral responsibility is not a matter of criminal liability. If we adopt the attributability aspect of responsibility, the primary sense of responsibility is the characterization of the subject’s inner structure with respect to value. Moral responsibility ascriptions expose the subject to appraisal as an actor or agent with a certain quality of will or character, commendable


or loathsome depending on the inner springs of his, her, or its intentional actions. Angela Smith writes,

To say that a person is morally responsible for something is merely to say that she is connected to it in such a way that it can, in principle, serve as a basis for moral appraisal of that person. What is in question here is the relation between an agent and her actions, attitudes, values, etc., and the conditions under which those things can be said to reflect on her morally ... should they turn out to exceed or fall short of certain moral norms or expectations.\(^\text{14}\)

In fact, Khoury persuasively points out that the moderate reasons responsiveness condition for membership in the moral community is met by a subject “is a fact internal to the agent’s mind.”\(^\text{13}\) It is entirely an internal condition that connects the motivational mechanism of the subject to the action.

Suppose a trader in a shadow bank is “hunting elephants” and offers an investor a securitized tradable instrument of tranched mortgages that he purports is undervalued and can be expected to increase in value, although he knows it is a garbage investment given the radical decrease in the value of the assets backing it. Perhaps he does so because he is under pressure from the head of his department to produce greater profits for the bank. The client buys the product, and when reselling it experiences a significant financial loss as the market has become information-sensitive to the value of the assets backing such instruments. The description of that consequence of the original transaction, “the client loses money on resale,” makes no reference to the trader’s mental states in selling the client the product. The occurrence of that consequence is external to the trader’s mental states, the springs of his actions, in making the original sale. His moral responsibilities should not depend on anything that, from his perspective, amounts to a matter of luck: the client being unable to resell the product at a profit.\(^\text{15}\) His moral responsibilities should link to his internal mental states, to what he wills, not to events that may have a causal relationship to his actions, but that are external to the workings of his neuro psychological mechanism, what Harry Frankfurt calls his will.\(^\text{16}\)

So he cannot be morally responsible for his client losing money on a future transaction involving the defective product. If things were to go another way—the client finds an even less informed buyer who pays him far in excess of the value of the product—the trader has not earned moral praise for having made the original deal that ultimately resulted in a benefit to the


\(^{15}\) It may be disputed, of course, as to how much luck is involved in such an outcome. I will stipulate in the case I have in mind that the trader has no particular interest in what the client does with the product after the original sale is completed. His only interest is in making the sale that profits the bank.

\(^{16}\) Harry Frankfurt, The Importance of What We Care About (Cambridge: Cambridge University Press, 1988), Chapter 2.
client. He is morally responsible, however, for his intentionally selling his client a garbage investment and claiming otherwise. If he sold the product with the intent of “ripping the face off the client” (structuring and selling a complicated deal that he has good reason to believe the client does not understand but that generates huge profits for his bank17) and expecting that the client will lose substantially on any attempt to sell the product, then that consequence (so described) is part of the scope of his moral responsibility because it is a part of his intention in acting. His intent is “face ripping.”

The reasonable expectability of a consequence and not whether the consequence actually occurs, however, also should be relevant to an individual’s moral responsibility. Suppose the trader sells the garbage instrument reasonably expecting the buyer will lose a substantial sum of money on resale, but the client locates that gullible purchaser who pays far in excess of the value of the assets backing the product and the client makes a nifty profit on the deal. It was still reasonable for the trader to expect the consequence he did when ripping the face off the client and he is morally responsible for acting on that intention + expectation, even though the actual consequence turns out to be radically different from what the trader expected. It may be a financial bonanza for the client, but it still indicates a morally deficient character or quality of will of the trader.

The relationship between reasonably expected consequences and actual ones is contingent, a matter of resultant luck. As already noted, resultant luck should not be the crucial factor in attributing moral responsibility to individuals for their willful actions. Imagine that the lucky client tells all of his friends what a great trader he dealt with because he realized a substantial profit. Knowing what we know of the trader’s intentions, would we not still hold the trader morally responsible in a negative sense for his actions in dealing with his client? If the outcome external to the trader doesn’t matter to his moral responsibility when the consequent turns out unexpectedly good, why should it matter to his moral responsibility when it turns out as bad as he reasonably expected? What matters is whether his intention, including his expectation in its scope, meets applicable normative standards.

In sum, individuals and corporations are responsible for what they intentionally do, not for consequences to which their actions may contribute that were external to the workings of their internal mechanisms, were not captured in the scope of their intentions, and do not reveal the moral quality of their springs of action. What is expectable or should be expected is important when we attribute moral responsibility to a member of the moral community, but whether what was or should have been reasonably expected actually occurs is not. We do not learn the moral quality of the internal mechanism of humans or corporations from the consequences of their actions. We learn it from their intentions and what they include and exclude within the scope of those intentions: reasonable expectations of consequences. “You should have expected

that outcome to result from your actions” is a revealing rebuke and it carries heavy moral weight regardless of whether that outcome actually does result. A reckless driver should expect a calamitous outcome from his actions, whether or not one actually occurs, when he goes swerving about in heavy traffic or barreling down neighborhood streets where young children are likely to be playing. He is morally responsible and blameworthy for his actions even should no tragedy ensue. Another way to see this case is to think about how the notion of due diligence is treated in ordinary moral discourse. If someone has exercised what is generally regarded as due diligence and met applicable normative standards in the performance of some task and yet her actions result in a catastrophe because the world does not cooperate with her intentions, she is not held morally responsible for that outcome. The scope of the shadow bank trader’s moral responsibility is set by two primary factors: what he actually intended and what he should reasonably have expected in forming his intentions. Therefore, the client’s reselling the product at a profit has no relevance to the moral responsibility of the trader in ripping off his client’s face.

It has been said or written in discussions of the Financial Crisis that Alan Greenspan (an individual) is morally responsible for “trumpeting the synergy between financial innovation and homeownership” that inflated the housing bubble, and that Goldman Sachs (a shadow bank) is morally responsible for promoting a corporate climate that encourages “its employees to ‘rip the face off’ their clients by structuring and selling complicated deals that clients do not understand,” and that the shadow banking system is morally responsible for inadequately protecting the securitization market by allowing the securitizing of loans with insufficient asset-backed collateral, thereby encouraging information sensitivity regarding debt. 18

In the case of the ascription to Greenspan, the consequence of inflating the housing bubble might not be something for which he is morally responsible. However, given his knowledge of economics and the operations of the Fed, it may be reasonable to believe that he at least should have expected the inflation of the housing bubble when he encouraged the financial innovations that included subprime mortgages. That being the case, the scope of his intention, despite any post facto denials, should include the consequence. But whether that intention exposes a morally flawed will or merely overenthusiasm for the innovative products he was encouraging is debatable. If the latter was the case, it still seems a flaw in his internal mechanism: a failure to carefully evaluate likely outcomes before using one’s position of power to “trumpet” recommendations. That lands the failure squarely in what Austin called the “machinery of action:” a failure at Greenspan’s stage of appreciation, 19 a thoughtlessness, a perverse interpretation of the facts, a lack of imagination, all indicators of weaknesses in Greenspan’s internal neuro-psychological mechanism with respect to values.

There seems to be little doubt that the corporate internal operational mechanism at Goldman Sachs was morally flawed to the extent that a culture of ripping the faces off clients was encouraged and rewarded. Monika Mitchell in the Huffington Post—“The Blog” of 3/14/2012—asked the question of Goldman Sachs employees: “How much can we pay you to rip the face off clients and still put your head down on the pillow at night?” The answers she received from senior executives at Goldman Sachs, she reports, were that “they feel trapped by a system that rewards only bad behavior and punishes good.” They recounted, she says, the Faustian choice they face: “sacrifice your hard-earned career and jump ship or sell your soul for a bonus and keep your moral conflicts to yourself.” Whatever the consequences of the face ripping by the Goldman Sachs employees, the facts about the internal operational mechanism of the firm as revealed by confidential interviews with employees support the negative moral responsibility attribution to Goldman Sachs.

Systems are relatively permanent arrangements of social relations, organized around a social need or value, that are created to meet that need or realizing that value. As noted above, systems involve rules that are built on shared beliefs and purposes within a society. Negative responsibility assessments of systems express claims that there is a moral flaw in the structure or the operations of a system. Fundamental in most systems is the capacity for modification, reengineering, of their internal structures to conform to moral principles such as justice and fairness, consequently forcing the restructuring of the entities that concretely embody systems. That is why moral responsibility assessments of systems are not empty rhetoric. If inadequately protecting the securitization market by allowing the securitizing of loans with insufficient asset-backed collateral is a fact about the shadow banking system, it identifies a flaw in that system’s internal structure that blocks its ability to meet the need for which it was created.

Expressions of moral responsibility and negative reactive attitudes, however, also commonly target collectives that might be composed of individuals or of corporate entities or a mix of each. Sometimes such expressions read as if their subjects are systems, such as the shadow banking system, but the speaker or writer does not mean them to target the named system per se. The name of the system then is being used as shorthand for picking out a collective: the entities that embody the named system. When that is the case, as in some of the rhetoric of the Occupy Wall Street Movement, “the shadow banking system” stands in for the collective


23. Slavery is a counterexample and so is a thoroughly immoral system.
of the various corporate entities that are active in global shadow banking and the humans, particularly the senior officers of firms, operating in that industry.

Suppose we read: “The shadow banking system is responsible for provoking the run that contributed to the economic collapse of 2008,” and discover that the writer is not pointing to a moral defect in shadow banking qua system, say in the way repo and the securitization market typically are handled within that system, but means that the collective of entities that are the primary players in shadow banking are morally responsible for provoking the run. The speaker may believe that the shadow banking system is an essential element of global finance and not particularly flawed when it operates in its customary way, but that some or many of its members adopted idiosyncratic or nonstandard ways of doing business within the system that led to the run. In that case, “the shadow banking system” for accuracy should have been replaced with “the shadow banking institutions and their employees.” That phrase picks out a variety of entities that may each be members of the moral community, while the shadow banking system qua system, of course, is not a member as it, qua system, is not normatively competent. How are collective responsibility ascriptions of this sort to be understood?

The notion of collective responsibility has concerned those working on moral responsibility for decades. Motivated by an intuition that one of my teachers, H. D. Lewis, who famously had condemned all collective responsibility ascriptions as barbarisms, must be wrong about the notion, I took some whacks at it in the early 1970s. In recent years, papers by David Silver and Andrew Khoury and a series of papers and discussions by Margaret Gilbert, Michael Bratman, and others have influenced some of my thinking about collective responsibility, although I wouldn’t presume to suggest that they would agree with any of my appropriations of aspects of their work in what follows.


A distinction between collective responsibility and individual–collective responsibility, as suggested by Khoury, is important to interpreting ascriptions of collective responsibility. Collective responsibility, on Khoury’s account, is concerned with the responsibility a collective qua group bears for a collective act. Following on work done on the topic by Virginia Held, I would argue that to be collectively responsible for doing something a group must have formed a functional decision and coordination action mechanism prior to the action or event for which responsibility is being assessed. Short of that, the group is just a random gathering of individual entities. That coordination mechanism may be as simple as the members agreeing by hand signals on the distribution of tasks or the time to perform specific tasks, such as four people about to raise a heavy object off of the leg of a fifth person by indicating to each other who is to lift what part of the object, and by agreeing to lift on the count of three and that the calling of the numbers by one of them will constitute the coordinating signal to do so. The rules and customary procedures in the shadow banking system provide a kind of coordination mechanism for the collective of shadow bankers. It functions qua system by coordinating actions and making responsive actions highly predicable.

Individual–collective responsibility is the responsibility an individual member of a collective bears for a collective action. It distributes the collective responsibility from the group to the individual; consequently, collective responsibility is conceptually prior to individual–collective responsibility. In the lifting of the heavy object the group of four is collectively responsible for the raising of the object and each is individual–collective responsible, likely to an equal degree in that case, for the raising of it.

Silver makes ownership the crucial factor in attributions of individual–collective responsibility ascriptions. Ownership of collective actions or events may come about in different ways. Suppose that X is a member of a collective C that did Y. X is individual–collective responsible for Y if X was a willing participant in the doing of Y. Call that “individual–collective participatory responsibility.” X is also individual–collective responsible for Y by virtue of X being a member of C at the time that C did Y, as are all of C’s members at that time regardless of their participation in Y. Call that “individual–collective membership responsibility.” But affiliation in a collective may come about in a variety of ways, not all of which may bear the weight of responsibility. For example, being born into a certain group or forced or coerced into joining may not be adequate to convey ownership of the collective’s actions on a member unless the member has in some way, not necessarily formally, acknowledged membership. Anchoring individual–collective membership moral responsibility crucially should involve some factual data regarding


the internal mechanisms of the members that confirms belonging to the collective and not just an externality over which the member has no control.

Khoury offers as the linking relationship that secures individual–collective membership responsibility “the degree to which the individual member of a given collective is psychologically connected to the mechanism that issued in the collective action.” For him, the strength or thickness of that connection determines the degree of individual–collective membership responsibility of humans. By “psychologically connected” I include the degree to which and the way in which a corporate entity’s internal decision structure’s policies and procedures connect to those that were the effective springs of the collective action. Consequently, both humans and corporate entities can be individual–collective membership–responsible for collective actions and events on a psychological connectedness account. The fleet of institutions and corporations, as well as individuals working in them, that form the shadow banking system understood as a collective may all have individual–collective membership responsibility for the collapse of the repo market and the collective’s role in fostering the practices that provoked it, even if some of the collective’s members did not materially participate in the actions that caused the collapse. 

Psychological connectedness (or operational mechanism connectedness in the case of corporate entities) to the collective’s operations and activities secures their ownership.

The other sort of individual–collective responsibility is participatory, and the degree or amount of such responsibility a member has for the collective’s deeds is a function of the member’s power and contribution in bringing about whatever event is the focus of the responsibility ascription that targets the group—in the case in question, the collapse of the repo market. Individual power within a collective is a crucial element in determining degrees of individual–collective participatory responsibility. Peter Morriss writes, “The connection between power and responsibility is … essentially negative: you can deny all responsibility by demonstrating lack of power. You can do this … by showing that you couldn’t have prevented the catastrophe. Power is a necessary (but not sufficient) condition for blame: if you didn’t have the power, you are blameless.”

To have power in a group is to possess the dispositional property of being able, if one wants, under certain conditions, to move a group to action or inaction. Power in this sense corresponds to what John Martin Fischer calls control. When someone has power with respect to a particular occur-

32. Khoury, “Types of Collective Responsibility.”


35. This analysis is based on Alvin Goldman’s “Toward a Theory of Social Power,” Philosophical Studies 23 (1972): 221–68.
Some Tranching of Moral Responsibility

rence or event, there is some action (or actions) that she can perform at an appropriate time that will ensure that the event will occur and there is some action (or actions) that she can perform at that time that will prevent the event from occurring. Invoking that principle, how should individual–collective participatory responsibility be assessed among shadow bankers in the case of the collapse of the repo market?

Imagine a collection of the major commercial depository banks and the shadow banks, the CEOs of those banks, the leading traders, mortgage companies, and so on, as many members of the financial community involved in the repo markets as you please, and call that collective the FINCRI MOB. The FINCRI MOB is not a corporate entity, but it is not a purely random collective like the people flying on a commercial airplane. Although it does not have an internal decision structure that incorporates the various members’ actions into a corporate act, it does function according to rules, practices, protocols, and customs that concert the actions of the various members of the MOB, indeed that make shadow banking and repo possible. For the FINCRI MOB to do what they, as a group, proved to have the power to do, the members had to have adequate information about how the shadow banking system functions qua system by coordinating actions and making responsive actions highly predicable. Minimal coordination sets the parameters on the lower end of the actualization of the latent collective power of the MOB.

The collapse of the repo market has occurred; the world’s economies are in turmoil. The FINCRI MOB is the prime suspect, but collective responsibility ascriptions with it as the subject must in some way be distributed among those in the MOB at least as attributions of individual–collective responsibility. Such a distribution can be handled in two different ways, as noted above: as individual–collective membership responsibility distributed equally across the MOB members or as individual–collective participatory responsibility distributed in degrees to those identified as having been directly involved in doing or refraining from doing things that resulted in the debacle and aligned with the power of each within the MOB with respect to those actions that contributed to the repo market’s collapse. Insofar as the collapse of repo clearly was an external consequence of the actions of the collective’s members and, I will stipulate, was not within the scope of any of their intentions, there are further steps that need to be taken to determine individual–collective participatory responsibility. Clearly, economists must identify the specific actions taken by MOB members that caused the collapse and the degree to which each contributed. That is a very complicated process on a par with trying to determine the degree of individual–collective participatory responsibility a member of a white lynch mob in the American South following the Civil War has for the lynching of an African American ex-slave if he stood in the crowd and applauded the hanging, as opposed to the degree attributable to the man who supplied the rope, and the man who fashioned the noose, and the man who kicked away the chair on which the victim was forced to stand, and the man who riled up the
mob with a vicious racist diatribe and ordered the various members of it to perform the different tasks that accomplished the lynching.

The FINCRI MOB collectively had power with respect to the collapse of the repo market, but that does not mean that each member of the FINCRI MOB had an equal amount of power with respect to that outcome. The power distribution principle in collectives, as I defended it elsewhere, may be summarized as follows: “A person (agent) has some power with respect to the occurrence of a collective event if a group of which that person (agent) is a nondispensable member has collective power with respect to the occurrence of that event.” I think we may grant that every member of the FINCRI MOB is not nondispensable with regard to performing the sorts of activities that resulted in the collapse of the repo market, even if all of its members acted in various ways that collectively brought about that outcome and are thus individual–collective participatory responsible for it to some degree. Someone is a dispensable member in a collective with respect to a certain outcome, if all of the members of that collective except that member wanted the outcome to occur, it would occur, regardless of that member’s opposition. A member is nondispensable in a collective with respect to a certain outcome if his or her or its opposition to the outcome’s occurrence is sufficient to prevent its occurrence, despite the fact that the other members of the collective wanted it to occur.

Suppose the question is whether one of the FINCRI MOBsters, for example, the CEO of Goldman Sachs, Lloyd Blankfein, had some degree of power to prevent the repo market collapse. In other words, was Blankfein nondispensable with respect to preventing the collapse? If he was, he is individual–collective participatory responsible for the collapse to a greater degree than many of the others within the MOB, even if he never intended the collapse to occur. Reasonable expectability will capture him in the web of moral responsibility.

There probably are some members of the FINCRI MOB that, no matter what they wanted to do or actually did because of the way the others regard them or the stations they occupy in the shadow banking system or within their corporations, the collapse of the repo market would not have been averted. However, surely there is a critical mass of members within the FINCRI MOB that had collective power with respect to the repo market, and each member of that critical mass subgroup had at least some modicum of individual power in the circumstances, if only the power of being in that critical mass. At minimum, had he, she, or it chosen not to be in the critical mass subgroup, critical mass would not have been reached. The weight of numbers may sometimes be the crucial factor in determining the critical mass for a group, but more often other factors such as social or corporate position, intellect, training, and so on will be operative in determining critical mass membership. The formation of a

critical mass that will move a collective to action often requires specific members to associate, and without those members concurring nothing gets done, or is prevented from being done, even if most of the collective members want it done or prevented.

In very random groups, like the passengers on a commercial airplane that is hijacked, it may be the case that the critical mass subgroup that can subdue the hijackers could be composed of any passengers because the critical mass may be nothing more than a certain number of passengers. But it may be that a smaller group of the most physically fit passengers are needed to form the critical mass, and therefore there are power differences among the passengers in the plane with regard to abilities that play a role in whether or not the hijacking is thwarted. When a group member projects or can exert strong influences on the other group members because of his, her, or its station or role or position within the collective, the subgroup with power to move the collective to do something or not to do something will almost always have to include that person or entity. He, she, or it is nondispensible. If Blankfein had such power (my suspicion is that he did), then he had individual–collective participatory responsibility for the collapse of the repo market to a greater degree than the run-of-the-mill members of the critical mass of the FINCRI MOB. Consistent with the position earlier maintained that attributions of moral responsibility to humans entail the belief that there is a moral defect in their neuro psychological mechanisms in some relevant respect with regard to values, it may be that the motivational flaw in Blankfein’s will, and the wills of many of the members of the FINCRI MOB, is greed. Rather than stand hard and fast against the practices of the employees of Goldman Sachs, where he definitely had indisputable power, and the injudicious activities of others in the FINCRI MOB, in which, because of the exemplar position of Goldman Sachs on Wall Street, he had power, Blankfein remained silent and raked in profits and bonuses.

With respect to the firms and corporations in the FINCRI MOB that can be identified as members of the critical mass subgroup and to whom a degree of individual–collective participatory moral responsibility is attributable for the collapse of the repo market, the flaw that such an attribution suggests in their organizational mechanisms may be the absence of appropriate feedback decision loops recognizing and correcting destructive corporate actions by employees and executives.

All of the members of the FINCRI MOB, it should be recalled, have individual–collective membership responsibility regardless of whether they were impotent with respect to preventing the collapse of the repo market. Collective responsibility cases, such as those involving the FINCRI MOB and the collapse of repo, reveal that ownership of and moral responsibility for actions and events can come about in a numerous ways that expose members of the moral community to blame and other hostile responses.

37. Johnson and Kwak, 13 Bankers, dedicate a chapter to the impact of greed on Wall Street.
Christine Korsgaard draws a distinction between theoretically construing moral responsibility and practically doing so. Theoretical accounts provide a list of conditions for an agent to be responsible for actions, attitudes, character, events, and so on, the sort of thing on which I have focused. Practical accounts look to the general moral community and attempt to answer the question “What attitudes, if any, should we take toward those we deem responsible (and culpable) for these things in the relevant sense?” Many people likely will opt for the practical when they learn of the practices, attitudes, and so on in shadow banking leading up to and during the Financial Crisis.

Being responsible is a fact about an individual, corporate entity, or a system. Holding responsible is adopting an attitude and undertaking subsequent actions toward an entity. The justification for having the attitude and acting negatively toward something, blaming him, her, or it, is that the object of blame is responsible for an untoward action or event in one of the many ways he, she, or it can be connected to that action or event, can be said to own it. But whether we ought to blame an entity and to what extent and how our naturally occurring negative reactive attitudes ought to be manifested in practical responses to those that incite them is a matter for another time. The members of the FINCRI MOB working in the shadow banking system are surely to blame for the collapse of the repo market, but whether all of them ought to be blamed or punished, and to what extent, is not a matter to be given short shrift, nor is it one I am prepared to undertake here.

2. CLOSING NOTE

These are preliminary thoughts regarding some of the issues I confronted in an attempt to assess moral responsibility in the shadow banking system for various aspects of the Financial Crisis. They arose after reading a variety of books and articles, mostly by economists, that purport to nail down responsibility, at least causally, particularly with respect to the collapse of repo and securitization. By and large, however, they left me unconvinced that the moral assessments they occasionally made were backed by defensible conceptions of for what members of the moral community can be morally responsible. Their technical accounts of the activities of the shadow bankers before and during the Crisis were cogent and most convincingly explained the crucial relationship between the unfettered operations of the repo market and information insensitivity and similar matters that were, at best, foggy to me and, I suspect, to many noneconomists. I have certainly left a plethora of substantive normative questions not only unanswered but also untouched. For examples, consider: What moral principles are relevant to identifying internal moral flaws in human neuro psychological mechanisms, corporate internal organizational mechanisms, and system procedures, protocols, and cultures? What effective desires


39. That is clearly the Occupy Wall Street approach.
constitute a morally defective will in a neuro psychological mechanism and why is greed thought to be near the top of the list? What are the more egregious moral defects in organizational mechanisms? What features identify a corporate culture as morally corrupt? When are corporate entities sufficiently morally mature to join the moral community and face the music of moral responsibility attribution? These and many other questions will have to occupy another occasion.
Collective Responsibility and the Purposes of Banks

STEVEN SCALET

1. INTRODUCTION

Who or what is morally responsible for the financial crisis? In response to reading popular accounts of the crisis, philosopher Peter French writes that “they left me unconvinced that the moral assessments they occasionally made were backed by defensible conceptions of what members of the moral community can be morally responsible for” (2018, 52). This essay develops one piece of a defensible conception that French says is missing: a connection between claims about responsibility and claims about the purposes of banks.

The first part of the essay discusses and compares French’s analysis of individual and collective responsibility, offered in this volume, with a recent account of moral responsibility by Chandra Sripada. These discussions serve both to clarify and narrow the terms of debate relevant for this essay. The second part develops background conditions for explaining the sense in which collectives such as banks can be held responsible. I argue that answering the question “Who or what is responsible for the financial crisis?” requires answering a question such as, “What are the purposes of banks?” Finally, I consider responses in the literature to the latter question about bank purposes, and draw out the implications for grounding an account of responsibility through an account of purposes.

By considering how to connect the concepts of responsibility and purposes, the focus of the essay is philosophical rather than empirical. Although limited in scope in this respect, the link between responsibility and purposes cuts across three academic literatures in business ethics: philosophical accounts of individual and collective responsibility, applied discussions of corporate

DOI: 10.1111/misp.12083
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social responsibility, and industry-specific debates about the legitimate purposes of banks.

2. INDIVIDUAL AND COLLECTIVE RESPONSIBILITY

This section analyzes two accounts of individual and collective responsibility relevant to an account of organizational purposes.

2.1 French’s Position

The notion of “responsibility” can mean many things, but French’s essay focuses on whether there are any moral issues about who is to blame morally for creating a mess distinct from questions about who caused the mess and who should clean it up.

French argues that human persons, corporations, and organizational systems can all be normatively competent; and so each type of entity can be susceptible to judgments of this type of moral responsibility. The intuitive idea is that any entity that can function to appreciate moral reasons, participate in dialogue, and form intentional actions in response to these reasons can be held morally responsible for what it does. What is essential to attributing moral responsibility to entities, French writes, “is what is internal to them, specifically their volitions or willings” (2018, 40). An entity is to blame for an action only if there is some defect in the moral reasoning or decision making that produced the action—the action becomes an expression of this defect.

French disputes none of these foundational intuitions—at least initially—and illustrates them with an example. He asks us to imagine that the financial crisis did not occur but everyone’s intentions and volitions were exactly the same as in the scenario in which the financial crisis did occur; intuitively, we should not change our attributions of moral responsibility to those individuals, if all the internal springs of action were exactly the same. French writes: “Individuals generally are responsible for their actions that under some true description were intended by them, but the consequences of those actions are
not their actions. They are externalities unless a description of them legitimately can be fitted into the scope of individual’s intention in acting” (2018, 41).

Already this brief discussion takes us into uncertain territory, French points out. He considers the shadow banker who convinces an investor to make a questionable investment, perhaps under pressure to make greater profits for a bank. The shadow banker, let us hypothesize, does not intend that the client lose money, only that the bank make profits; so when the client loses money on the resale, the shadow banker is only morally responsible for the intention (of selling the questionable instrument), not for the consequence of the action (the client losing money on resale). For example, the client could get lucky and sell the instrument to another unsuspecting buyer for a huge gain. French grants that “his moral responsibilities should not depend on anything that, from his perspective, amounts to a matter of luck: the client being unable to resell the product at a profit” (2018, 44). One puzzle, however, is that this view seems to absolve individuals of blame too readily, by reducing their sphere of moral responsibility to such narrowly characterized actions that it seemingly releases people from blame for all the consequences of their actions. If every action includes at least some luck, then this account, taken to its limits, may undercut any attribution of responsibility to an individual apart from the willing itself.

French responds by endorsing the view that moral responsibility should extend to what agents can or should reasonably foresee will result from their actions. Supposing that the shadow banker can reasonably expect that the client will lose a substantial amount of money, then that consequence “is part of the scope of moral responsibility because it is a part of his intention in acting” (2018, 43). It may turn out that the client makes a profit on resale or not; but the scope of moral responsibility extends to what is reasonably expected to happen, not what actually happens. Reasonable expectability, French emphasizes, is about “what is expectable or should be expected” (2018, 43). This account is designed to extend the scope of blame beyond the action itself but without sacrificing the foundational intuition that blame must always trace to the internal mechanism—the intention of the responsible party.

With this general criterion of moral responsibility in hand (action + reasonable expectability), French argues that no satisfactory account of moral responsibility for the financial crisis can focus only on individuals. If we only took account of the intentions and reasonable expectations individuals, French believes, we would be left with an anemic and inaccurate understanding of what happened and who can be held responsible for the financial crisis. Corporations and systems can be morally responsible, as well, he argues, and this fact is “no empty rhetoric” because these larger units can be responsive to reasons, and they can re-engineer their decision-making processes as a result.

In this way French’s overall vision can be divided into two parts. One part is an account of moral responsibility based on actions + reasonable expectability. The second part applies this normative core to all entities that can be normatively competent, which include human individuals, corporations, and systems. Taking these parts together, French’s essay emphasizes that any viable
moral analysis of something like the financial crisis must include a careful analysis of the actions and reasonable expectations of collectives. From French’s perspective, recognizing the importance of collective responsibility does not undermine or obscure claims about individual responsibility—rather, collective responsibility can heighten individual responsibility, because people can be individually responsible for being a member of, or participating in, a collective that is found to be morally responsible.

2.2 Sripada’s Position and Comparison with French

Chandra Sripada also traces the idea of responsibility to the internal states of the person and calls this class of theories “deep-self” or “real-self” views of responsibility (Sripada 2015, 2016). He traces these views historically to John Dewey, David Hume, and Aristotle; and notes the resurgence of these ideas in the writings of T. M. Scanlon, Nomy Arpaly, Angela Smith, George Sher, Sarah Buss, Susan Wolf, Harry Frankfurt, Gary Watson, and others (Sripada 2016, 1205). French’s analysis is one illustration of a deep-self view.

Sripada focuses solely on individual responsibility, although it may be possible to extend his discussion in ways useful to ascriptions of collective responsibility. Sripada argues that the relevant question about responsibility is whether an action belongs to or expresses the deep self of the person, and this deep self is constituted by what matters to the person, which is distinct from the intentions, endorsements, deliberative choices, or other agentially demanding conditions of being a person. He writes, “You are morally responsible for your actions that reflect the person you really are, the actual content of yourself” (2016, 1212). This self can be revealed through spontaneous and non-deliberative actions, below the level of awareness, such as

forgetting birthdays and anniversaries, attending to things one shouldn’t, spontaneously finding certain (perhaps inappropriate) things amusing, and spontaneously experiencing emotions such as contempt, jealousy, or indignation. Notice this conduct does not appear to be reflectively endorsed or governed by one’s valuational system. (2016, 1213)

For Sripada, the relevant challenge is to identify when an action “stands for” or “stands against” the real self that one is.

If Sripada’s basic intuition is correct at the individual level, then the corresponding question at the collective level is whether it’s possible to identify what the corporation is, in the sense of what it “cares” most about, and to

1. What if the deep self is substantially formed by other people or by no one at all? Then aren’t actions in keeping with that jointly formed self partly their responsibility or no one’s responsibility? If so, one’s true self may not be one’s own. Sripada does not address these questions. Perhaps, like Aristotle, Sripada simply takes as a premise that what constitutes being a person is just that we are responsible for our deep selves. This fundamental challenge is currently at the forefront of robotic technologies and debates about whether machines that are like people can have deep selves like people. I thank the editors for raising this challenge to Sripada’s position.
trace responsibility from the resulting events to an analysis of whether those events accurately express what the corporation stands for, where this may not be a matter of its self-image or brand, but what its behavior suggests might be its true self. These concerns might be expressed through its mission, or its cut-throat business practices, or, as I will argue below, through an account of its purposes. In contrast to French, Sripada’s account of responsibility understands the sources of the self as originating below the level of deliberation and awareness. Thus, the internal mechanism need not be decisions or decision making per se. The more fundamental idea for him is that responsibility traces to what matters most to a person. These sources refer to what the person most cares about at the level of an individual person; in corporations, an analogous system might refer to the ethos, mission, or purposes of an organization. In this respect, one point of discussing organizational ethos, mission, or purpose can be about identifying what the organization is really about—what really matters to that organization, as an organization.

Although Sripada’s analysis has some notable differences from French’s position, and his project does not apply ideas of responsibility for holding collectives responsible, both stress that legitimate claims of responsibility must trace to some internal feature of the person (or entity). Second, even in French’s case, this internal source cannot be merely direct intentions or conscious deliberations, as French broadens his view to include an account of reasonable expectations. Before moving to the next section, let’s consider the similar challenges that both French and Sripada confront.

A significant attraction of reasonable expectability is that it provides an intuitive middle ground between two answers to the following question: “Why tie moral responsibility to an internal mechanism at all?” French’s answer is that our willings or intentions are under our control, not due to luck or factors external to the willing itself. If we grant that our intentions are under our control in the requisite sense, we may conclude that we can only be blamed for bare intentions, because as soon as we introduce any measurable activities that result from the intention, those activities will be due in part to factors outside a person’s control. The mere ability to move our own human body depends on much over which we have no control. On this initial view, we can only blame what people intend, not the resulting actions. Insofar as this view has any attraction, the position faces the challenge that it seems untenable to believe that it implies what may seem implausible, that people have no responsibility for their actions. Whatever the resolution to this puzzle, the solution won’t be found by claiming that actions are unaffected by luck, whereas the consequences of actions are so affected. Both actions and their consequences are affected by luck. At the other end of the spectrum, we could abandon these metaphysical tangles entirely and provide a purely consequentialist grounding for holding people responsible: we ought to endorse whatever blaming practices yield the best consequences for society on some standard, with no principled answer based on any supposed truths about luck, control, or personal identity.

French states that a person can be responsible for whatever is within the reach of the content of the intention, which can sometimes or often include both the action and the expected consequences of that action. The shadow
banker intended to make a profit but reasonably expected the client not to lose much money on the deal, and so French argues that this reasonable expectation becomes part of the intention of what the shadow banker is responsible for. A problem, however, is that French includes not only what the shadow banker actually expects to happen but also what the shadow banker reasonably should have expected to happen, even if the shadow banker, in fact, did not expect that to happen. What justifies this expansive account of blame? French’s position allows that people can be held responsible for outcomes that are not part of their intentions or what results from those intentions.

Thus, for both French’s and Sripada’s premise, responsibility appears to trace to and express an internal feature of the person, but to make sense of the range of assignments that we make about our moral responsibilities they extend the analysis beyond (or underneath) intentions. In this respect Sripada and French are similarly challenged to uncover these internal features of the person, unless French denies that there is a deep self internal to or inside the person. In Sripada’s case, we see how responsibility traces to actions that spring from features of the person’s deep self—what in reality matters most to that person. French’s analysis of reasonable expectations may dovetail with Sripada’s account in this respect, depending on how he further explains what we can reasonably expect of people for the purpose of praising or blaming.

The value of presenting Sripada’s and French’s discussions together is to suggest further possibilities for developing an analogue to collective responsibility. Whether or not we agree with Sripada on the individual level, his discussion offers creative application at the collective level where it may be even more appropriate. Sripada’s analysis suggests that particular ascriptions of responsibility need not presume intentionality or deliberation—they presume an account of what matters most to the person. Thus, if an application to a collective is possible, then questions of collective responsibility will depend on developing an account of what matters most to a collective as part of explaining what that collective is.

3. PREMISES ABOUT COLLECTIVE RESPONSIBILITY RELEVANT FOR THE FINANCIAL CRISIS

Can collective entities, such as banks, be in some sense morally responsible for the crisis? With French’s and Sripada’s theories in hand, I will consider why judgments of collective responsibility matter and the relevance of purposes for developing an account of collective responsibility.

3.1 Why Judgments of Collective Responsibility Matter

Critics of collective responsibility may presume that blaming a collective competes with or distracts from claims about individual responsibility; in fact, however, collective responsibility is compatible with and may even be a basis for ascriptions of individual responsibility. The point is epistemic and arises from limited access to various sources of information. Consider a professional
sports team whose tactic in games lead to repeated patterns of injuries to opposing players. Initially, commentators may analyze whether or not this contact crosses any lines; so the first step of debate is to argue from these clearly observable outcomes to the conclusion that there is a problem, if there is one. Suppose that these arguments make headway and lead to an op-ed piece that says: “this is not a league problem, in one way or another the team is responsible for that objectionable behavior.” It may turn out, after further investigation, that some members of the team are more responsible than others; it could be the result of policy or tacit sanction in ways that heighten owners’ and coaches’ responsibility. Or it may not be possible to determine anyone’s individual responsibility with any degree of confidence, given conflicting accounts or obscurity about the reasons why a climate that supports such behavior developed. Despite those further details, or disagreements about those details, the op-ed is articulating what it believes is a common and consensus judgment of collective responsibility, that says: “the organization as a whole bears responsibility, whatever the remaining details about how to identify individual responsibility.”

As a practical matter, presumptive collective assessments can be a first step in a process leading to a deeper investigation. The commentators may not have, or yet have, the facts to answer questions about the role of individual players in causing injuries, but the judgment of collective responsibility can spur this next level of questioning. It remains to be seen what this claim of collective responsibility could mean, if it’s not semantically reducible to the responsibility of particular individuals. Thus, this initial point is a practical and epistemic claim. Assigning responsibility to collectives often has the benefit of motivating and focusing efforts to identify individual responsibilities rather than ruling them out.2

Second, holding a collective responsible can motivate and create substantive findings about who should take responsibility for correcting the problem. The distinction between holding and taking responsibility is often important from a practical point of view. By holding the collective responsible, blame is directed at the collective: a wrong is said to have occurred. This judgment can motivate an analysis of how, and to what extent, individuals within the collective are distinctly responsible. But taking responsibility can be more important. Suppose that the team is collectively responsible for increased sports injuries because they have adopted questionable tactics: it may then be possible to conclude both that no particular individuals are distinctly responsible (for lack of direct evidence), but that individuals ought to take responsibility to be sure it stops. In this way judgments of collective responsibility can be a crucial prior step for motivating individuals within particular organizational

2. It may be that the presumptive case for collective responsibility is mistaken and the investigation reveals that the problem is isolated to a few individuals, a result that I consider below. Examining this distinction, in fact, could be a leading question in the sports scenario: To what extent is the problem collective and to what extent individual? I thank the editors for raising this point. This question presumes the possibility and value of making judgments about collective responsibility, which underlines the arguments of this section.
roles to assume responsibilities for fixing the problem. For example, the coaches may initially disown responsibility for injuries. But if they became convinced (or pressured to acknowledge) that it’s a problem, they might step up, and be right to do so, even if they believe that they had nothing to do with it. A key feature of this practical connection is that the strength of the reactive attitudes, aimed at the collective level, can drive individual actions to take responsibility at the individual level. That the organization is to blame for the bad outcomes spurs the need for individuals to take responsibility to correct the problem.

In addition, judgments about holding and taking responsibility can complement one another. For example, consider ascriptions of collective responsibility to the team that yield no clear lines for specifying individual responsibility. This result can be demoralizing when a collective judgment leads to the conclusion that no one is to blame for that outcome. In these cases, converting the analysis to which individuals will take responsibility, given one’s role in an organization, can complement and make more productive the initial inquiry.

Willingness to take individual responsibility can depend on or only be possible after a thorough investigation of who is and is not to blame is complete, so as to clear the names of those who step up to take responsibility. For example, if the coaches are cleared of any individual responsibility, they may be more willing to take responsibility, as their actions are likely to create praise for stepping up. However, if their individual responsibility is murky and unsettled, they are more likely to take a defensive and nonresponsive posture, as the act of taking responsibility is likely to be interpreted as admission of guilt. This entire complex process often begins through claims of collective responsibility across the organization as a whole, not in spite of those findings.

Finally, a third reason to take seriously judgments of collective responsibility is that people routinely make these judgments. People routinely say that corporations or teams or collective units are responsible. What is more, companies invite these judgments by appearing to hold themselves to promises made in the first person plural, such as “We guarantee so and so” or “Our promise to you is,” and so on. To reject the semantics of collective judgments of responsibility would require revising our language or developing an error theory according to which people who make these judgments do not know what they mean. When people blame an organization as a whole, they seem to mean that services or products offered corporately are substandard for reasons that go beyond individual shortcomings. The responsibility attaches to the offering agent, which is corporate. Whether or not ascriptions of collective responsibility are semantically reducible, the starting point, as is the approach of this essay, is to begin by trying to make sense of them.

James Dempsey (2013) provides an instructive framework for debates about collective and individual responsibility. One “strong intuition”, he writes, is that people commonly praise, blame, and judge corporations and organizations, as discussed above. Another strong intuition is that only individual human beings can be fully morally responsible, which cuts against the first
intuition. The challenge, he notes, is to account for individual and collective responsibility in ways that do not reject either intuition out of hand.

In keeping with this framework, the benchmark for a successful philosophical account of collective responsibility will be to preserve a role for making collective judgments that (1) can support and complement judgments holding individuals responsible and individuals taking responsibility and (2) does not reduce the meaning of collective judgments in ways that would undermine how people take those judgments seriously.

The reasons offered in this section to take seriously ascriptions of collective responsibility are epistemic, practical, and semantic, not ontological. Given limits about how to find individuals responsible in complex networks, given the practical value of making claims of collective responsibility for investigating wrongs committed in organizations, and given the common semantics of how people express claims of collective responsibility, there is a presumption in favor of making sense of these judgments. It may be possible ontologically to reduce claims about collective responsibility to truths about individual responsibility. It’s not the purpose of this essay to address that debate. This essay develops an account that proponents on either side of that ontological debate might find useful.

3.2 What We Need in an Account of Collective Responsibility: An Account of Purposes

One approach argues that individual moral responsibility entails agency; so any collective entity bearing moral responsibility must be an agent (French, 1984; Hess 2014a,b. A second approach maintains that individual moral responsibility does not entail agency, so that the collective entity can be something other than an intending, deliberative agent. Dempsey (2013) exemplifies the second approach, and Sripada’s analysis offers a creative application of this approach as well.

A challenge for strong accounts of agency as a prerequisite for responsibility is that its application to collectives yields what many people believe are counterintuitive implications—that collectives possess characteristics that most people apply only to individual persons. For example, a recent defense of a strong account by Hess (2014a,b) requires her to show how the view does not imply any “special pleading” when many critics believe it does. A second approach widens the scope of responsibility that can apply to collectives with seemingly fewer counterintuitive results at the collective level (Dempsey 2013). My comments elaborate a position within this second approach as it relates to the financial crisis.

To begin, let’s return to the question that opened the essay: Who or what is responsible for the financial crisis? Let’s suppose that we are attracted to the following claim: whatever else may be responsible, the banking system is to blame for those terrible outcomes. This assertion begins with a recognition of bad outcomes, traces the cause of those outcomes to an organizational system, and then (evaluatively) blames that entity for those outcomes. A
preliminary question is what the phrase “banking system” could refer to, but let’s take its meaning for granted, if only for the moment, so as to focus on the idea of blaming a collective. How to identify the relevant collective, such as a “banking system,” is addressed directly below, given the results of the initial analysis.

The viability of making moral judgments about collectives depends on at least the following conditions.

First, following the discussion of deep-self views, the financial crisis would be an expression of some feature internal to that collective, such as the culture, policies, or ethos of particular banks or the banking system, depending on the relevant collective. This condition relies on the analysis in Part 1, accepting the premise that any successful account of responsibility, whether individual or collective, depends on identifying an internal feature of the person or entity that contributes to bringing about the event.

Second, as Dempsey argues, the agents responsible cannot credibly be only individual persons—there is an explanatory remainder (Dempsey 2013, 342–43). If it were possible to trace the financial crisis entirely to the actions of individuals (who might be described as a few “bad apples”), then the financial crisis is an accident from the perspective of the collective. In this case a broader culture or the system would not be at fault and would misdiagnose the problem.

A third condition derives from the best way to link (1) the fact that an outcome expresses an internal feature of a collective to (2) the judgment that the collective is good or bad, to be praised or blamed. For example, suppose that we grant that the financial crisis was an expression of some internal feature of the banking system. What justifies our holding the banking system at least in part morally responsible, beyond any claims about causal responsibility? A preliminary response, common to Sripada and French’s analysis, and which I accept for this discussion, is that assigning collective responsibility must be due to features of what the collective is or does. Thus, judgments that the collective is good or bad cannot be grounded solely through external sources—for example, solely because it caused harm—but also by reference to internal features of what it is or does that justifies the resulting attribution of moral responsibility.

What could those internal features be? To judge an institution as bad, there needs to be a standard that the institution is judged not to meet. What could both express a standard and be internal to a collective at the same time? I argue that if the collective has a purpose or purposes, then these purposes indicate standards by reference to which claims of responsibility can be proposed and evaluated. If no purposes can be attributed to the relevant collective or organization, then there are no internally derived features on which to base an ascription of responsibility to the collective as a whole. Purposes become a necessary part of describing what constitutes that organization and express the “deep” sense of what the organization is. If a bank has a set of purposes, and the financial crisis occurred because the bank operated in ways that violated those purposes, then in that sense it becomes
possible for the bank to be criticized and held responsible for its failure to live up to its purposes.

This conceptual connection, I argue, explains how it’s possible to make judgments about collectives: we attribute purposes to the collective, which constitute an internal feature of the collective. We hold the collective responsible depending on how the resulting events express or violate those purposes. Corporate purposes are different from the purposes or motivations of any given individual within that corporation, and yet they can be crucially important for understanding what that corporation is and what explains its activities as a whole. In sum, a third condition for claims about collective responsibility is that it must make sense to attribute a purpose or purposes to the relevant collective to develop claims that it can be responsible for the wrongful events that occur.

In listing these conditions, the aim is not to provide all of the necessary and sufficient conditions for establishing collective responsibility. The aim is to highlight and consider the implications of the special role of purposes as appropriate philosophical backing for making claims of collective responsibility. Let’s consider the implications of this approach.

(i) In the case of the financial crisis, is the relevant collective the global banking system, a regional banking system, the particular bank, or other collectives? We can push the question further by investigating whether the subsidiaries within a particular bank constitute their own collectives as well. One value to the analysis provided above is that it provides a structure for answering these questions. In order for a collective to be responsible, there must be a description of the collective with a unified identity conferred by its purposes. The “banking system” as a whole may or may not meet this condition. It depends, for example, on whether there are trade associations, governing rules, or shared corporate cultures where a purpose can be identified for understanding that collective as a whole. Claims about a “corporate culture” may reflect features particular to that corporation or features that reflect norms as part of a greater collective. These questions are significantly empirical. They rely on an explanatory theory of collective identity, and on my argument, discussions of collective responsibility hinge on being able to conceive of a set of institutional activities in terms of some unified purpose or purposes. Consider this analogy: in higher education, should all...
of higher education be considered a collective or are the purposes of research universities and regional teaching colleges so different that there is no higher level description about which a purpose can be described to explain these institutions as part of the same collective? Labor markets and employment patterns across institutions illustrate one set of relevant factors for answering this question. If faculty at research universities and regional teaching colleges move across these institutions for employment and engage in common activities at professional associations, then university education may be a relevant collective beyond the boundaries of a single institution or a single class of higher education institutions. On this view, if it’s true that the only way to understand certain educational norms and their prevalence is by reference to this larger collective, then the sources of these norms will be fundamentally misunderstood if they are reduced to the activities of the particular institution. A particular university can also have purposes distinctive of that institution, which are separate from its purposes as part of the larger collective. Banking is analogous. It’s not the aim of this essay to answer the relevant empirical questions to identify which collectives are most important for analyzing the financial crisis. The ideas presented here rather prompt a criterion: the relevant collective must identify a set of causally related activities that fall under a description of having a common purpose.

(ii) Note how the link between reactive attitudes directed to the collective entity and its purposes does not presume strong agency requirements that we attribute to individual persons. We need not conceive of the collective as a deliberative agent. Drawing on Sripada’s analysis, the key factor is that purposes can identify a meaningful or deep sense of what the collective is. We can then critically respond to an outcome caused by the collective by reference to a violation of this internal normative feature of that collective. Reactive attitudes embodied in judgments that the collective is functioning badly or is to be praised or blamed express the belief that the resulting events stand for or against that purpose. Because the purpose is about the collective as a whole, the tracing of responsibility to individuals would misidentify the relevant purpose. Drawing on French’s analysis of reasonable expectability, this account suggests that the line between reasonable and unreasonable expectations at the collective level can be interpreted in relation to identifying the purposes of the collective. For example, in the case of a particular bank, these purposes need not be interpreted literally as willings or volitions in the sense of agency. They may operate below the level of intentional awareness or consciousness.

4. The expressions “stand for” and “stand against” come from Sripada (see, e.g., 2016, 1222).
of any individual, and yet are part of what the collective is, for explaining its operations as a whole. This account allows for a distinction between individuals (as agents) and collectives (not as agents), but also makes sense of reactive attitudes directed at a collective. The reactive attitudes make sense in the light of an internal feature of the collective analogous to the deep self of individuals. We blame the collective because reference to its purpose identifies not merely any internal feature of the collective but what matters most in making the collective what it is.

Applying this analysis to the sports case discussed earlier, the op-ed writer could hold the team responsible for this repeated injurious play if it’s true that the purpose of the sports team is to compete to win under conditions of fair play, and those behaviors violate fair play. If that is the purpose of the sports team, then it is internal to the organization—it helps to constitute it as what it is. In the absence of evidence to assign individual responsibility for fully explaining the event, it becomes justified to blame the organization as a whole, for violating its fundamental purpose, which can then drive further analysis for holding and taking individual responsibility.

(iii) Linking collective responsibility to purposes also invites a re-examination of the distinction between causal and moral responsibility. The collective may cause an outcome, but to justify reactive attitudes toward the collective requires assessing that the collective has done something good or bad, and in some normative sense is at fault for the outcome. Let’s consider three cases: (1) the outcome is a damaged home and a tree is held responsible for the damage; (2) the outcome is injury-ridden game playing and the team is held responsible for the bad play; and (3) the outcome is deception and the individual person is held responsible for the deception. The first case implies causal responsibility but does not normally entail reactive attitudes of judging the tree as bad or blameworthy. The tree example, presumably, is a case of causal responsibility alone. The third case implies moral responsibility that often entails thick reactive attitudes, including blame, with meanings that connote and are backed by claims that the person is an agent who intended the deception. The second case, on my argument, might occupy a middle ground, not only about the nature of its internal features but also the meanings of the judgments that result. We judge that the collective (the team) is responsible in a sense that goes beyond mere causal responsibility, as in (1). It’s not merely that the bad behavior is best explained as caused by the team. The claim includes an additional normative meaning: people criticize the team and believe that the team deserves this judgment. However, we do so without
ascribing moral responsibility in the same sense as we do individual human beings.

To mark this distinction, consider three ways to be “held” responsible: causal, purposive, and moral. The specific terminology is not important except to indicate that the distinction between causal and moral responsibility is not sufficient to understand the reactive attitudes relevant to judgments of collective responsibility. When the collective violates its purpose or purposes, we can judge the collective good or bad relative to these purposes. These normative judgments about collectives can spur the reform of these institutions. They become practical when individual persons can impact those purposes. On this account, a collective without purposes cannot bear purposive responsibilities at all, and in that case reactive attitudes toward the collective are inappropriate, presumably as in (1) above. But once it’s possible to identify a collective purpose independent from the motivations of individuals participating in the collective, then in that sense it can be coherent to direct the reactive attitudes toward that collective itself.

Thus, to hold the collective responsible is to direct attention to its underlying purposes.

(iv) Let’s apply these ideas to the financial crisis. The distinction between causal and moral responsibility now can include the further distinction introduced above. The types of reactive attitudes that are appropriate depend on whether we are discussing individual human persons (with strong accounts of moral responsibility and agency) or collectives (with an account of their purposes). This discussion preserves the intuitive idea that collectives need not be conceived as persons but they still can warrant reactive attitudes. Those who judge the collective are expressing the belief that the event, such as the financial crisis, is not merely bad, but happened because it was an expression of nonaccidental features of the relevant collective. The relevant collective may be a particular bank or the banking system—it depends on partly empirical arguments about the conditions that enable a description of that collective as a unified set of causally related activities that share a common purpose. Attributing the purpose is justified when necessary for understanding what that collective is. Absent the need to attribute a purpose to those activities, there is no need to attribute responsibility to a collective. Thus, “banks” may or may not refer to the relevant collective. As in the case of understanding higher education, the answers depend on detailed empirical arguments. But if banks have purposes and the crisis was an expression of important features of that collective, then it’s possible to direct criticism to the collective itself.
4. BANKS

4.1 Corporate Social Responsibility of Banks

Do banks have purposes? One way to begin this discussion is by reviewing recent academic literature on the corporate social responsibilities (CSR) of banks. As a basis for reviewing this literature, there are three relevant pieces of background. First, this literature does not always appeal directly to the concept of “purpose,” but the analyses often imply an account of purpose, as I will indicate below. Second, this literature by and large takes for granted that collectives can be held responsible, although this point requires some clarification. The literature tends to use the concept of responsibility generically to mean “obligations” or “duties” or “what ought to be done.” Thus, the search for “corporate social responsibilities” is often about what corporations ought to do, if anything, beyond maximizing profits within the law. This broader concept of responsibility connects with the narrower concept of holding corporations responsible relevant to this essay, given that CSR analyses often imply that corporations deserve praise for fulfilling their responsibilities and deserve criticism for violating them. That is, corporations ought to be held responsible for living up to the obligations that are implied by the best account of CSR. Third, this literature does not always engage banking debates about the appropriate firewalls across consumer and investment banking. Unless otherwise specified, “banks” in this literature refer to institutions that engage in the broad range of commercial banking activities.

David Sigurthorsson (2012) considers how and why the Icelandic banking sector (150) was responsible for bad banking as part of the collapse of the Icelandic economy in the global financial crisis of 2008. It’s not entirely clear whether he ascribes responsibility to the sector as a whole or only to each of the three banks that he analyzes, but as his discussion focuses on those three banks, he appears to identify each bank as the relevant collective. His main contention is that when these three banks engaged in positive duties of corporate philanthropy, they may have diverted attention from the more fundamental responsibility of fulfilling negative duties of protecting constituents against risk. He writes: “This type of bad—or irresponsible—banking may well be regarded as violation of the banks’ negative fiduciary duties owed to their stakeholders … not to a) gamble … with their livelihood … or b)—jeopardise macro-economic and social stability” (154). Although some scholars, such as Bert Scholtens (2009), write approvingly of the banking industries’ increasing emphasis on philanthropy, Sigurrthorson argues that there is a disconnect between those philanthropic activities and their ensuing role of bad banking in the financial crisis. He traces bad banking to activities that promote risky behavior for stakeholders and society at large.

Yves Fassin and Derrick Gosselin (2011) document the fall of the Fortis group, a major European banking and insurance provider that collapsed as part of the financial crisis. They also emphasize and argue for a
disconnect between, on the one hand, philanthropic corporate social responsibility with its formal CSR guidelines and, on the other, failure of the bank to fulfill its fundamental responsibility of assessing risk (170). They explicitly emphasize the collective perspective and note that dissecting the crisis based on individual responsibility can only go so far: “The whole system of watchdogs and regulative authorities failed completely. Analysts, relayed by the press, auditors, rating agencies, and the official institutions were not up to the job” (173). They believe various collectives bear responsibility, including particular banks: “the fundamental questions that arise are whether a firm that takes on that level of risk is really socially responsible and why the powerful CSR guidelines did not help in the assessment of the risks” (187). Both Sigurthorsson (2012) and Fassin and Gosselin (2011) share the view that assessing the collective responsibility of a bank (or banking sector, as it may) depends on how those institutions carry out risk assessments.

Elisabeth Paulet, Miia Parnaudeau, and Francesc Relano (2015) analyze the impact of the financial crisis of 2008 with an emphasis on a distinction between “ethical banks,” which restrict investment banking in the financial markets, and “mainstream banks,” which include investment banking. They write that “the main activities of ethical banks are concentrated on the original business of banks: savings collection and credit distribution” (201). Their empirical study is about distinguishing the behaviors of ethical and mainstream banks. They found that mainstream banks, which for them include banks that engage both retail and investment banking, had become more cautious about engaging in risky behavior, based primarily or solely on following new regulations, whereas ethical banks maintained a steady approach to their operations over time, as their practices already discouraged risky investments. The authors are concerned with “how to figure out an optimal arbitrage between profit maximization and ethical practices in the banking industry to guarantee financial stability worldwide” (206).

On my argument, an analysis that holds banks collectively responsible for the crisis requires an account of the purpose or purposes of banks to back claims of responsibility. On this analysis, the literature needs to clarify and defend the relevant collectives based on a discussion of purposes. Without providing a complete answer to questions of responsibility, this literature all points in the same direction: they premise their analyses of particular bank responsibilities on the belief that at least one fundamental purpose of banks is to ensure a type of financial stability to a market system that protects stakeholders and society at large from overly risky investments.5

5. This analysis need not undermine claims that a purpose of a government is to create financial stability through a regulatory system. For example, banks may have a purpose of stability but because they cannot bear that responsibility alone, governments may then carry that responsibility as well, through regulations.
4.2 Banks and Purposes

Johan Graafl and Bert van de Ven (2011) provide an instructive approach for identifying purposes. First, they argue that it is “too simplistic to blame the financial crisis and its consequences on the personal vices of the financial professionals involved” (606). An account of the crisis is not possible, they state, through an assessment of individual responsibilities. Instead, Graafl and van de Ven identify large collective units, and systems within systems, such as government institutions, U.S. policy making, lax regulations, commercial banks, credit rating agencies, buyers of derivatives, and the short-term focus of shareholders, to indicate the complexity of the collectives that are to be blamed for the crisis (606–08). The crisis was not an accident from a collective perspective but was an expression of features internal to those systems.

They focus their attention on commercial banks by sifting through such banks’ mission statements. Even if organizational behavior fails to measure up to lofty mission statements, they provide one basis for identifying an internal criterion of what banks are. They conclude that “the mission of banks is to serve the interests of customers by providing them with relevant financial products at competitive prices” (608). This statement of purpose leads Graafl and van de Ven (2011) to identify specific virtues that banks acknowledge in their mission statements as necessary for achieving this purpose. These include honesty, integrity, due care for consumer interests (who are in a disadvantaged position with respect to information), and accuracy of the associated risks in banking. They refer to Joseph Stiglitz (2010) to identify core functions of the banking system as a whole in a capitalist system, which includes “an efficient payment mechanism (in which the bank facilitates transactions, transferring its depositors’ money to those from whom they buy goods and services), and the assessment and management of risk and making loans” (Graafl and van de Ven 2011, 613).

Graafl and van de Ven (2011) provide the most detailed discussion in the literature of the purposes of banks and how identifying these purposes has implications for risk management. On my analysis, if it’s possible to identify purposes of a bank, which might include an analysis of mission statements as well as the role of banking in a capitalist system, and other factors, it might be possible to hold a bank collectively responsible for an outcome traced to the behaviors of that bank. If it’s possible to identify purposes of a banking “system,” whether it be constituted by various regulatory structures, labor markets, or other features, it might be possible to hold that system collectively responsible. It’s not the role of this article to give an account of how to establish the purpose or purposes of the respective collectives, but as illustration, their approach to mission statements, and the mission statements of related professional associations that tie the banks together, offers one method for that investigation.

Furthermore, the codes of professional ethics contained in mission statements can guide a further examination of the responsibilities of individuals within that system, given the finding of collective responsibility. In this way,
an account of collective responsibility can support rather than undermine efforts for individuals to be held responsible and to take responsibility.

Graafland and van de Ven (2011) also contribute to this discussion by suggesting, in the case of the financial crisis, how systems are nested within other systems. They write: “the blame for the credit crisis cannot solely be put on banks and their individual managers displaying a lack of virtues, but also on various systemic shortcomings inherent to the Anglo-Saxon model of capitalism” (616). The implication of this essay is that commentators committed to blaming larger systems have the task of identifying the purpose or purposes of those systems to justify and give content to judgments of collective responsibility.

In sum, the literatures on corporate social responsibility of banks and the professional responsibilities of bankers suggest a consensus that managing risk in making loans is a fundamental purpose of the banking system. This section illustrates how an analysis of purposes such as these can be part of the philosophical backing for making claims that a collective, such as a bank, can be held responsible.

5. CONCLUSION

Collective responsibility depends on the purpose or purposes of the collective entity being held responsible. The essay considers the implications and limits of this thesis, especially as it is relevant for assessing responsibility for the financial crisis of 2008. One fruitful implication of this approach is how academic literatures in philosophy, business ethics, and management can be linked and convergent in their conclusions. Connecting responsibility to purposes requires the integration of philosophical accounts of individual and collective responsibility, applied discussions of corporate social responsibility, and industry-specific debates about the legitimate purposes of banks.

If we take for granted that holding individuals responsible can be justified and appropriate based on what a person is, the next question, for analyzing an event such as the financial crisis, is whether collectives can be held responsible based on what a collective is or could be. This question matters not only because people commonly attribute responsibility to collectives across many spheres of life but also, for practical purposes, claims of collective responsibility often motivate efforts to mete out individual responsibilities within the collective.

If efforts at arriving at an account of collective responsibility come to naught, then we may be left in need of an error theory that explains why people attribute responsibilities to collectives when that may not make sense. This essay explores some of the conditions necessary for making meaningful claims about collective responsibility, and focuses on one feature: whether it’s possible or not to characterize a collective in terms of its purpose or purposes. The viability of directing reactive attitudes about responsibility toward the collective, I argue, is premised on developing a substantive account of these purposes.
The discussion about banking serves to illustrate the practicality of pursuing questions of purpose. Not only does the link between responsibility and purpose include theoretical arguments on its behalf, but there are methods already developed in the literature for arguing about what the purposes of an institution, such as a bank, might be. A discussion of banking is an especially useful application because many people blame features of the banking system or particular banks for a substantial part of the financial crisis of 2008. A complete account of collective responsibility for the financial crisis depends on defending how and whether the relevant institutions and systems that contributed to the crisis have purposes and what they are.6

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6 I am especially grateful to Josh Kassner, Dennis Weiss, Kenneth G. Scalet, and the editors for their comments on earlier versions of this draft. The University of Baltimore provided a sabbatical that allowed invaluable time to complete this article. In addition, York College of Pennsylvania provided the use of their research facilities as a Visiting Scholar for the academic year 2017–2018, as did the University of East Anglia as a Visiting Scholar during Fall 2017. Finally, Binghamton University continues its support for my research as a Senior Research Scholar. I am thankful for all of this institutional support.
Banking Culture and Moral Responsibility for the Financial Crisis

JAMES DEMPSEY

1. INTRODUCTION

One of the striking features of the aftermath of the global financial crisis that began in 2007 is the sense of public frustration at the lack of accountability that has been established. At most, a few high profile senior executives from the businesses most centrally implicated in events have been hauled before public enquiries on both sides of the Atlantic. Some have lost their jobs; some have had to forego part of a pension, or a knighthood. Whether these penalties are appropriate or not for these individuals, they do not address the main source of concern. Popular critiques that focus on the culpability of “greedy bankers” are not targeted at only a few at the very top of organizations, but at those organizations and the financial sector more widely. But, by and large, wider attempts to ascribe and justify culpability have found little purchase, and the sense of frustration that this has generated has been further fuelled by a growing sense that—for financial sector employees at least—the crisis was a temporary blip that is now being overcome as the sector returns to “business as usual.”

My aim is to offer an account of why a significant proportion of financial sector employees can be held morally accountable for the events of the financial crisis, by focusing on the nature and effects of the culture of financial organizations and the financial sector more widely.¹ The idea I develop starts

¹. In developing this account I draw on arguments that I make in James Dempsey, “Moral Responsibility, Shared Values, and Corporate Culture,” Business Ethics Quarterly 25 (2015): 319–40. It is worth noting that it is not intended to be an exhaustive account of how moral responsibility for the crisis may be ascribed, or even for how it may be ascribed on the basis of the nature and outcomes of corporate culture—for example, it does not consider ways in which shareholders may be responsible, or the special responsibility that may accrue to organization leaders.

DOI: 10.1111/misp.12084
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with the thought that standard attempts to find individuals accountable for macro-level events such as the crisis fail, except in the special case of very senior leaders, because the individuals seem too far removed from those events. It is often unclear how their actions contributed to the events under consideration and, even if such a connection can be made, it is doubtful they could have predicted these results. Related to this, it seems hard to sustain that, in so acting, they did anything blameworthy. My appeal to organizational culture is intended to overcome these barriers to attributions of individual responsibility. I argue that corporate culture can be held to independently determined moral standards, and that individuals have derivative obligations not to contribute to morally objectionable cultures. Moreover, these are obligations that organization members can readily discover and understand. When a morally objectionable culture results in harmful outcomes, those organization members who culpably contributed to the culture are morally responsible for the outcomes, even if they could not have predicted that exactly those outcomes would result. In this way individual culpability for harmful corporate outcomes is mediated by corporate culture, thus overcoming the epistemic and practical barriers to holding individuals responsible for macro-level outcomes.

The structure of my argument is as follows. In §2, I develop an account of organizational culture that captures the way that term is employed in morally charged criticisms of business organizations and their members, for example, the kinds of criticisms leveled at financial sector institutions in the aftermath of the crisis. This is an account based on the “goal-oriented” values that organization members share, and I explore ways that value sharing may occur in practice. §3 argues that one particular way of sharing values—and hence creating culture—is particularly common in large business organizations, such as those that populate the financial sector. Moreover, it shows that by sharing values in this way each organization member acquires an element of causal responsibility for the actions that other organization members take in pursuit of those values. It also outlines three further conditions that must be satisfied if this causal responsibility is to be translated into moral responsibility. §§4–7 show why this model is appropriate for ascribing moral responsibility for the financial crisis to individuals working in the financial sector in the run-up to those events. In §4 I argue that the nature of the financial sector places particular obligations on participants, in particular an obligation to value, and engage in, good risk management. Financial sector employees therefore do wrong to the extent that they subordinate this value to others that are less important, such as the value of personal gain. §§5–6 then argue that not only was such wrongdoing widespread prior to the crisis but it (1) played a significant causal role in the precipitation of those events; and (2) was driven by a culture that was widely supported throughout the financial sector. In §7 I argue that financial sector employees quite generally possessed sufficient knowledge about the activities in which they were engaged, and through which they contributed to the culture in question, to ground their share of
moral responsibility both for the wrongdoing that precipitated the crisis, and the events of the crisis itself. Moreover, I show that common ways of justifying such activities do not generally work in this case. §8 concludes.

2. ORGANIZATIONAL CULTURE AS SHARED VALUES

“Culture,” in the sense in which it is used in the kind of morally charged criticism in which I am interested, may be understood as the set of shared values that is endorsed by a group. The kind of group that I am interested in is a typical business organization, particularly the kind of large business organization that dominates the financial sector in the United Kingdom and the United States. However, many varieties of group are capable of establishing shared values; in the case at hand whole business sectors—such as the financial sector—may also share values in a way necessary to participate in a shared culture. This conception of “culture” is subtly distinct from standard accounts found in the literature. The two disciplines that have had most to say about what culture is are sociology, where “cultures” are conceived as things that groups have, and anthropology, where they are conceived as things that groups are. It is the sociological conception that has come to dominate, and this leads to the idea that culture “refers to the taken-for-granted values, underlying assumptions, expectations, and definitions that characterize organizations and their members.”

From this conception various detailed models have been developed in an attempt to understand, measure, and control corporate cultures. These models have a number of features in common: they tend to characterize cultures as falling along one or several value-based dimensions—for example, dimensions that set “flexibility and discretion” against “stability and control,” and “internal focus and integration” against “external focus and differentiation.” These models also typically focus on similar kinds of values; specifically, those that determine how organization members coordinate their activity. Moreover, the aim of these various models is similar—to help organizations become “effective” through taking control of, and molding, their cultures in ways which allow them to achieve their goals.

While this sociological conception of corporate culture is based on shared values, it is quite different from that which is at work when such culture is invoked in moral criticism of business organizations and their members, such as that which has been leveled at financial sector organizations in the aftermath of the crisis. Such criticism is not interested in the values according to which organization members coordinate their activity; rather it is interested in the values that underpin the goals that the organization pursues. A corporation will not be subjected to moral criticism as a result of endorsing “flexibility” over “control”; it may well be criticized for endorsing the pursuit of corporate profits over customer interests. The kind of shared values identified in the


3. Ibid.
sociological conception of culture I will call “coordination-oriented values,” those that are relevant to moral assessment “goal-oriented values.”

This idea of culture as goal-oriented values that are shared within an organization is also quite different from the kinds of ideas employed by the philosophy literature that deals with the analysis and moral assessment of organizations and the activity they undertake. While differing in various ways, particularly between “individualist” and “collectivist” accounts, these analyses all tend to fall back on the notion of joint action to explain how organizations make a difference to our understanding of the way individuals act and how responsibility should be ascribed as a result. However, joint action is not synonymous with having shared, goal-oriented values, and it does not depend on or imply such value sharing either. Nor does moral criticism of an organization on the basis of its culture presuppose joint action.

In order to use this idea of culture as the basis for ascriptions of moral responsibility to individuals within business organizations, and in particular to ascribe moral responsibility for the crisis to financial sector employees, an account of what it means to “share values” in the relevant way is required. In a useful discussion of different ways in which values may be shared within a group, Margaret Gilbert starts by arguing that to value something is to have a belief that the thing in question is valuable, although she does not think her account of shared values rides on the acceptance of this argument. I follow her in this understanding of what it is to value something. She goes on to identify three different accounts of what it might mean for a group to share values: the “summative account,” the “complex summative account,” and the “joint commitment account.” Her aim is to determine if and when shared values confer sufficient “unity” on a group for individuals to have the normative standing to intervene in each others’ actions. I am also interested in how shared values create group unity, although my aim is to determine if and when this unity is sufficient for individuals to acquire at least an element of moral responsibility for the actions of others within the group and the outcomes that result.

On the summative account, values are only shared insofar as group members all happen to endorse the same values; there is no presumption in this


5. This point is demonstrated by considering how joint action is characterized in the literature as depending, for example, on joint intentions, or shared goals, where the fleshing out of these notions makes no appeal to shared values or similar ideas.

case that they are each aware that they share values in this way. The complex summative account, however, makes the addition of “common knowledge” where this means “that it is completely out in the open among the members of the relevant population that everyone has certain values in common.” This addition is significant as it removes reasons that group members may have for refraining in intervening in each other’s actions. Whereas under a simple summative sharing of values they may fear the reaction they would provoke through intervention, this fear is lessened when all know that they have values in common. The joint commitment account of value sharing creates an even stronger unity between group members, however, as it requires that they together enter into a commitment to value certain things. Here, Gilbert draws on the theory of joint commitment that she has set out in depth elsewhere.

According to Gilbert’s joint commitment account, group members together decide to believe as a group that certain things are valuable. This process is supposed to be quite unremarkable, and is something we see regularly in everyday life when groups of people jointly commitment themselves in all sorts of ways: to “intend, believe, accept, value, despise, hate and so on.” Having made this commitment, each member is committed to acting in line with it until it is rescinded, something which can only happen as the result of another group decision. A feature of such joint commitments is that they imply nothing about the individual commitments of those who participate in them. In the case at hand, the joint commitment to value certain things implies nothing about what the group members value as individuals. The important consequence of a joint commitment to value, for current purposes, is that it creates a normative unity among the group, with each member having an obligation to all others to behave in certain ways—ways which promote the values to which they have all committed.

7. Ibid. Italics in original.
8. Ibid., 32–33.
10. The idea of a group deciding to believe something sounds, at best, awkward. It is, however, plausible in the context of Gilbert’s broader account of joint commitment, which I discuss in more depth in Dempsey, “Moral Responsibility, Shared Values, and Corporate Culture.”
13. It is worth noting that, in developing the joint commitment account of shared values, Gilbert defends a collectivist approach. However, as I have argued elsewhere, the main conclusions she reaches—and that are relevant for my argument here—do not require us to come down on one side or the other of the collectivist / individualist debate. See Dempsey, “Moral Responsibility, Shared Values, and Corporate Culture.”
Each of these three accounts of value sharing is plausible, they are not mutu-
ally exclusive, and it is reasonable to think that the existence of any of them is
sufficient to establish the existence of a kind of culture—provided the “right kind”
of values are being shared (what I have called “goal-oriented” values). Having said
this, it is worth re-emphasizing a significant distinction between the two versions of
the summative account, and the joint commitment account—the former require that
each party to the value sharing personally endorses the values in question, whereas
the latter does not. This, it turns out, makes the joint commitment account particularly
relevant to large business organizations of the kind implicated in the financial crisis.

3. BUSINESS ORGANIZATIONS AND RESPONSIBILITY FOR THE
ACTIONS OF OTHERS

To determine which, if any, of the three accounts of value sharing applies
in a given situation, consideration of the particular features of that situation
is required. The particular context in which I am interested is that of large
business organizations in the financial sector, and that sector more broadly,
as it is the culture of such groups that, I will argue, connects individual
members to the events of the financial crisis in a way that allows them to
bear moral responsibility for those events. While it is entirely possible that
any of the three accounts of value sharing could apply within a business
organization, there are reasons for thinking that such organizations will tend
toward sharing in the way described by the joint commitment account.

Business organizations are typically characterized by the way in which
members engage in habitual courses of action, often described in the language
of “practices” and “behaviors.”14 It is through such practices and behaviors
that joint commitments are established between members to value certain
things. A brief theoretical explanation of this claim follows here; the later
parts of this study offer more detailed justification by developing a narrative
of events of the financial crisis which shows this mechanism at work in prac-
tice. Habitual ways of acting often predictably promote certain values and
subordinate others.15 By engaging in habitual practices and behaviors that
predictably promote value \( V \), members of business organizations signal their
willingness to join with other members to act as if they together hold value
\( V \). This is not the same as each individual member signaling that she personally
holds value \( V \), as she may be engaging in the relevant practices for
reasons other than to promote that value. Nonetheless, by signaling that she
is willing to act consistently in a way which does promote \( V \) she allows herself

14. This is the language that is used, for example, by Antony Salz, *The Salz Review: An

15. They often predictably promote certain values, but it is not always the case that they do so.
Where the values a practice promotes are ambiguous, or potentially conflicting, engagement in
that practice will not provide the mechanism for entering into a joint commitment to value. The
examples I provide in my later discussion are intended to be ones in which the values being
promoted are clear.
to enter into a joint commitment with other organization members to promote that value in the future. Practices and behaviors thereby provide a mechanism by which joint commitments to value may be formed. Indeed, in Gilbert’s view a joint commitment to value is formed when all group members express their readiness to enter into the commitment, and also become aware of a similar expression of readiness on the part of all others.\textsuperscript{16} In the case of business organizations, these criteria are satisfied when members habitually engage in value-laden practices and behaviors, and see others do the same.

Illustrating how values are shared within business organizations is the first step in establishing the moral responsibility of individual organization members for the outcomes of corporate culture. Here I understand “the outcomes of corporate culture” to include the actions other organization members undertake as a result of the existence of that culture and the outcomes of those actions. The next step is to show that sharing values in this way connects each organization member with the actions of all others in a way that grounds a degree of\textit{ causal} responsibility for those actions. The final step is to show that additional conditions hold which allow\textit{ moral} as well as causal responsibility to be ascribed. The causal connection is established since the relationship that exists between organization members who share a culture with each other gives each of them reasons to promote the shared values that are constitutive of that culture. The nature of these reasons was set out in §2. When group members share values according to the complex summative account, they are freed from reasons they may otherwise have had for not acting in line with those values—reasons based on fear of disapproval or reprimand. When values are shared on the joint commitment account, however, positive normative reasons are created to pursue those values.\textsuperscript{17} These reasons are grounded in the obligations that each participant in the commitment takes on to act in line with it.

Members of a group that act in line with the obligations that they have acquired through such a joint commitment are, in effect, acting on reasons that each other group member has contributed to them having. Thus, a causal link is established among each member, those actions, and the outcomes of those actions. A natural way of capturing the relation is to say that all organization members who participate in a culture are\textit{ complicit} in the actions of those who act in line with that culture. This use of “complicity” is endorsed by Lepora and Goodin in their multifaceted treatment of the term.\textsuperscript{18} Of the various notions that they identify under this heading, the one in which I am interested is that of “secondary wrongdoing,” where an individual contributes to the wrongdoing of others without himself participating in the wrongdoing.


\textsuperscript{17} Gilbert argues that joint commitments do not establish\textit{ moral} reasons to act, but they do nonetheless bind the participants together in a normatively significant way (see, e.g., Gilbert, \textit{On Social Facts}, 162.

\textsuperscript{18} Lepora and Goodin, \textit{On Complicity and Compromise}. 
In particular, the way that individuals influence others to act in line with certain values through participation in a culture is best captured by what Lepora and Goodin term “complicity simpliciter,” a term which captures actions of complicity that “might induce or incentivise the wrongdoing … or encourage it … or make it easier to perform.”

A natural objection to the causal link suggested, between participants in a group culture and the actions of members of that group taken on the basis of that culture is that, in large groups where many people participate in a culture, it looks like any one of them is causally irrelevant to any outcomes the culture brings about. Lepora and Goodin provide a response to this objection: the relevant kind of causal relationships, given that we are ultimately interested in questions of moral responsibility, are not just those in which an individual’s actions are “definitely essential” to the production of an outcome, but also those in which they are “possibly essential.” As moral assessments are made of individuals ex ante, the fact that an individual’s contribution to a culture could have been essential to bringing about the outcome is sufficient for him to be “on the hook” for it. Being “possibly essential” is, in fact, a pretty low hurdle to clear and indeed it is cleared in the case of many individuals contributing to the actions of others through the influencing effects of corporate culture, just as it is cleared in other familiar cases of overdetermination.

Establishing a causal connection between all participants in a corporate culture and the actions each takes under the influence of that culture is not sufficient to ground the moral responsibility of all participants for all of those actions. To take this further step three additional conditions must be satisfied:

(i) The actions to which each individual contributes through participation in a culture must constitute wrongdoing.

(ii) Each individual must know (or be in a position to know) that she is contributing to wrongdoing.

(iii) There must be no further considerations that would either justify or excuse the participants in the culture.

Thus, to establish that individual financial sector employees bear moral responsibility for the financial crisis, my argument must proceed in a number of stages. In the next section I will say something about the kinds of actions that contribute to wrongdoing in the financial sector; in doing this I will focus

19. Ibid., 42.

20. Ibid., chap. 4, especially section 4.1.

21. For such examples see Lepora and Goodin, On Complicity and Compromise, 64–65.

22. These conditions are, I take it, congruent with those discussed by Lepora and Goodin in their treatment of moral responsibility. Lepora and Goodin, On Complicity and Compromise, chap. 5.

23. Here I am focusing on moral responsibility for wrongdoing. Of course, individuals may be morally responsible for doing good as well.
on one particular kind of wrongdoing—that which prioritizes the generation of profits and bonuses over the good management of risks which the sector is under a strong obligation to manage well. §§5–6 then provide a narrative of events that led to the crisis which illustrates how a culture existed in the financial sector which prioritized the generation of profits and bonuses over other important values, including that of good risk management, and how this culture led to those events. Having established that financial sector employees quite broadly can be causally linked to wrongdoing which precipitated the financial crisis through their contributions to the value system which underpinned this culture, §7 addresses the remaining considerations necessary to ascribe moral responsibility: it shows how such employees possessed—or could have been expected to possess—sufficient knowledge to be culpable for their contribution to this wrongdoing, and how this, indirectly, also grounds culpability for the crisis itself. It also offers reasons for why the most commonly invoked justifications for the behavior of financial sector employees do not offer widespread mitigation of this culpability.

4. WRONGDOING IN THE FINANCIAL SECTOR

For the purposes of this study I will take the financial sector to include all those organizations defined by the International Monetary Fund (IMF) as “financial corporations.”24 My working assumption is that my argument applies to all such corporations and their employees.25 Rather than try to produce a comprehensive list of kinds of wrongdoing that such individuals may undertake, I focus on one standard that is most relevant to the events of the crisis. In simple terms, the claim is that financial institutions should place high value on the management of risk, and particularly that the effective management of risk should not be subordinated to other values, such as that placed on financial rewards, particularly short-term rewards, accruing to those institutions and their members.26 The first source of obligation to manage risk that applies to the financial sector stems from the relationship that the directors and employees of a firm have with its owners. These are generally investors who own shares in the company, particularly large institutional investors such as pension funds and insurance companies. The prevailing model of corporate governance holds that a principal–agent relation exists between the directors of a company (and indirectly its


25. This said, my account is US- and UK-centric, and may not apply so generally to the financial sectors of other countries. Moreover, particular organizations or groups of organizations may prove to be exceptions to the rules of behavior I set out. Given that they are exceptions, however, such claims may be evaluated on a case-by-case basis.

26. This is a very general standard. Each institution will be required to manage a variety of risks, and this variety will vary from institution to institution. §§5–6 provide more detail. However, the general obligations to manage risk outlined here apply both across different kinds of institution and different kinds of risk.
employees) and the owners of that company. That is, the directors together act as agents, managing the business according to the wishes of the owners. This principal–agent relation brings with it a variety of obligations on the part of the agent, one of which is to manage the risks to which the business is exposed. When standards of risk management in corporations are assessed it is generally in terms of the degree to which they meet this obligation to business owners.

Financial services employees do not just have obligations to the owners of their organizations, however. A second set of obligations extend to the clients who they serve and others with whom they come into contact in the course of their business activity. These can be termed “professional obligations,” although this label may be misleading as it may imply that these obligations only apply to those taking up membership of professional bodies. But this fact is largely irrelevant to the question of whether or not an individual is under a duty to her clients or customers. While such obligations are often codified by the establishment of professional bodies and their regulations, they exist whether or not formal structures are put in place to recognize them—in other words formal codes of ethics recognize already existing obligations, generated by the nature of the activity itself.

Two particular features are common to activities that generate professional duties. The first is that practitioners of the activity have an informational advantage over those they serve—the nature of the activity is such that it is hard for nonexperts to know exactly what service is required, and when it is performed well. The second is that the performance of the service has the potential to generate significant impacts both for clients and for society at large. This combination of asymmetric knowledge and significant impact generates fiduciary obligations on the part of practitioners—duties to engage in the activity in question in such a way that the interests of clients are promoted. 27

The activity of the financial services sector generates fiduciary duties on the part of practitioners to their clients and customers. Practitioners have both an informational advantage over their customers, and the potential to cause them significant harm, in the provision of financial services. The aspect of financial services that most obviously generates these features is the management of risk. As Jamie Dimon, CEO of JP Morgan puts it, if you are in banking, you are in “the risk business.” 28 The risk to clients of loss from an investment is at the heart of the specialist knowledge of financial sector employees, and so this group acquires a fiduciary duty to their clients to manage the risk to which they are exposed. While this fiduciary duty is usually cast as stemming from the “professional” nature of financial services, it can also be argued that that it falls under general obligations of corporate governance. This line of argument is particularly strong in the case of financial services where clients provide businesses with one of their major sources of


funding. However, such an approach runs counter to the fundamental principle of shareholder supremacy that underpins the Anglo-American model of corporate governance.

There is a third source of obligations to manage risk that applies to the financial sector, and this is what Tom Sorell has called the “public dimension” of financial institutions. There is a sense in which the financial sector can be considered part of the public sector, and its institutions public institutions. This is not to deny that banks and other financial sector businesses are private enterprises, but rather to point out that these private organizations fulfill what is in many ways a very public role. The functions that the financial sector provides, in particular the most basic one of acting as an intermediary between savers and borrowers, are fundamental functions that are necessary to the successful operation of any modern society. This idea can be formalized by saying that the financial sector, through its constituent institutions, constitutes part of the Rawlsian “basic structure” of society. This makes such institutions susceptible to judgment against standards that are appropriate for the assessment of public functions and go beyond the promotion of private interests.

This approach to the status of banks finds support in the Salz review of Barclays’ business practices. In the case of the financial sector the basic public function that is performed is one of risk management, embedded in the intermediation function. At the very least, in order to fulfill its public mandate a bank must perform this role well. In other words, it has public obligations to manage risk. In the case of businesses and industries that are recognized to have public duties, regulation typically holds them to these commitments, but it is exactly this regulatory restraint which has been absent in the financial sector in recent years. The obligation to uphold these public duties does not, however, disappear with regulatory laxity; rather it passes to participants in the sector themselves.

5. FINANCIAL SECTOR PRACTICES AND THE FINANCIAL CRISIS

The framework that I have set out allows moral culpability for the effects of a corporate culture, understood as the set of shared, goal-oriented values, to be extended to the members of the corporation or business sector in question, on the basis of their participation in the joint commitments that create that culture. Here, and in the next section, I set out a narrative account of the


31. On John Rawls’s account, these are standards of justice.

32. Salz, Salz Review, §2.5. A similar view is also expressed in Macey and O’Hara, “Corporate Governance of Banks,” 102.
practices that were prevalent in the financial sector in the run-up to and during the crisis. The intention is to demonstrate (1) that through participation in these practices financial sector employees created a culture that did not place a high value on good risk management; and (2) that the culture so established played a significant causal role in wrongdoing that precipitated the crisis.

The management of risk is a fundamental feature of financial services. The most basic function of a banking system is to act as an intermediary between savers and borrowers, and this necessarily involves incurring different kinds of risk. Credit risk is the risk that borrowers fail to maintain payments on their loans; liquidity risk, on the other hand, is related to the fact that the intermediation function involves a liquidity transformation—banks accept deposits from savers and provide loans to borrowers, where the latter are typically of longer duration than the former. In a traditional retail banking model this means that there is a risk that savers will demand funds that banks do not have available to pay.

In the run-up to the crisis a particular funding model—the originate-to-distribute model—was widely adopted that broke the link between savers’ deposits and bank loans. A bank would sell on, or “distribute,” both the credit risk and the stream of returns associated with a loan to a third-party investor, with the payment from the investor taking the place of savers' deposits as funding for the loan. In fact, the process was often more complex than that, as loans would not be sold on individually, but would rather be packaged together into bundles, with the bundles then cut up in different ways to produce different combinations of risk and returns in a process called “securitization.” Loan pools would typically be divided up to produce some high-risk and high-return securities, and some low-risk and low-return securities. Part of the appeal of this process was that the low-risk securities could attract high credit ratings from the credit ratings agencies, so making them attractive to certain institutional investors.

The originate-to-distribute funding model changed the nature of both credit risk and liquidity risk, and in ways that led directly to the central events of the financial crisis. Traditionally, the institution that originated a loan would hold onto the credit risk associated with it. This meant that it was relatively straightforward for the institution to assess the risk that was being created, and it had an incentive to do this well. In the new model, not only was credit risk passed on to third party investors who purchased securities but also the chain by which securities were created was so long that it was hard for those investors to make a good independent assessment of the underlying credit risk. Moreover, as institutions originating the credit risk no longer held onto it, a moral hazard was created whereby there was little incentive for them to assess the risks well or to take on sensible risks—only to issue loans with high yields.

This problem was illustrated by the explosion of the subprime mortgage market in the United States. The nature of liquidity risk also changed. Whereas traditionally a bank had to worry about savers withdrawing money that had been lent long-term, in the new model the funding was coming from third-party investors. However, the same risk existed in a different form. Those investors typically did not buy securities with a maturity as long as the loans that underpinned them. Instead, a bank would have to reissue the securities several
Liquidity risk was now generated in the form of investors refusing to rebuy securities that they had previously owned, and no other investors wanting to buy them instead.

It was the combination of these risks generated by the originate-to-distribute model that precipitated the events that formed the epicenter of the financial crisis. Defaults on certain types of loans, particularly US subprime mortgages, rose much higher than predicted. In other words, the credit risk of those loans had been badly underestimated. Not only were these risks underestimated, but because of the complexity of the securitization process and the markets for those securities, it was unclear exactly which products were affected and who held them. This led to a situation where no one wanted to hold certain kinds of securities at all—liquidity in these markets completely dried up, and in a way that had not been predicted by assessments of liquidity risk. Financial institutions suddenly found themselves holding assets that they were struggling to fund and exposed to mounting costs of credit defaults, the risks of which they thought that they had passed on to third parties or were so small as to be ignored. The sudden weakening of the positions of many such institutions led to a knock on liquidity effect that, again, had not been predicted by assessments of liquidity risk. As well as funding loans through securitization, it had become common to attract funding from the wholesale money markets, where large sums of money could be borrowed for relatively short periods of time. However, banks stopped lending to each other as they each hung on to as much capital as they could, and other institutional investors, uncertain which financial institutions were in trouble, stopped lending to any of them. With liquidity drying up, banks found that they were struggling to fund their balance sheets; this was the “credit crunch” that sparked the financial crisis.

6. INSTITUTION AND INDIVIDUAL-LEVEL PRACTICES

While operating the originate-to-distribute funding model was a sector-wide practice, a focus on activities at the level of particular institutions and the individuals who populate them helps explain how certain practices both led to the misassessment of risks just described, and were undertaken in contravention of obligations to put sufficient value on good risk management. It also


34. This focus on institutional and individual practices is important because use of the originate-to-distribute funding model is not enough, of itself, to demonstrate a failure to value good risk management. Indeed, part of the attraction of the model is that it is supposed to allow risk to be distributed to those best placed to hold it. As noted in note 15, above, where the reasons for engaging in a practice are ambiguous, it cannot contribute to a culture as it does not constitute a clear expression of a set of values. This section, however, is intended to provide examples of practices that did contribute to a culture that failed to put sufficient value on risk management. They are practices that cannot plausibly be interpreted as stemming from a motivation to manage risk well, as opposed to a motivation simply to maximize short-term profits.
James Dempsey illustrates how institutions and individuals not directly involved in the new funding model nonetheless contributed to the culture that promoted the under-valuing of risk management through engaging in practices in their particular spheres of influence. Consider as an example a standard case of a structured finance deal, where the underlying loans are residential mortgages.\(^{35}\)

The first institution in the chain is the “originator” who makes the loans. The fact that the originate-to-distribute funding model allowed originators to pass on the default risk of their loans meant that such risk ceased to be a factor in those institutions’ profit calculations. Rather, given the high demand for asset-backed securities, the more loans they could make and the higher the yield on those loans, the more money they made. Of course, as set out earlier, this did not free them from their obligations to manage risk effectively, but nonetheless in many cases these obligations were neglected in the pursuit of short-term profit. One of the most extreme cases of such activity was Countrywide, a US lender that as of September 2013 was facing a lawsuit in the federal courts, accused of originating toxic loans and dumping the credit risk by selling them on to Fannie Mae and Freddie Mac—housing finance institutions sponsored by the US government—while earning origination fees in the process.\(^{36}\)

From the perspective of the individuals involved, while it is true that company policy was set from the top—by the now infamous CEO Angelo Mozilo—it is simply not possible to establish a system that consistently originates loans in a manner which neglects good risk management practice without the participation of members of the corporation through all the management ranks to the agents who ultimately assess, issue and process the loans. It may be objected that the fact that these more junior organization members were acting under the influence of senior management, and were incentivized to act in this way, absolves them of responsibility. However, in acting in this way all such individuals were engaging in at least \textit{prima facie} wrongdoing. Whether they should bear moral responsibility on this basis is a question I tackle in §7.

The second link in the securitization chain is the “arranger,” which is the bank or other financial institution that brings together the assets to be used and sets up the structure of the security tranches. Given that it was these institutions that bought the (often toxic) assets created by the originators and passed them on to third party investors in the form of securities, the same accusations of dumping bad credit risks on others for the sake of short-term profits can be leveled here. However, there was an additional way in which banks overrode risk controls in order to push up profits. Government regulation imposes limits on the value of assets that banks can hold. Such regulations


specify the amount of capital that a bank must have available as a percentage of the value of those assets; the main international regulations of this kind are set out in the Basel Accords. However, it was common in the run-up to the crisis for banks to get around these regulatory requirements by setting up separate companies known as “special purpose vehicles” (SPVs). The assets upon which the securities were to be based were then transferred from the bank to the SPV, and as they were no longer on the bank’s balance sheet they no longer fell under the remit of the regulations. The problem (and the trick) was that in many cases, in order to ensure that the securities issued had high credit ratings, the bank extended a credit line to the SPV. If the securities could not be reissued, the bank would step in to fill the funding gap, and so was still “on the hook” should investors want to get their money back. It was the fact that these credit lines were less than one year in duration that allowed banks to avoid regulatory requirements to hold capital against those guarantees.37

This account could be taken to show that moral culpability within banks must be limited to a relatively small subset of individuals—some specialist teams that ran the securitization process, and senior management who oversaw (or at least should have overseen) their operations. This is where the implications of my argument are perhaps strongest. In engaging in the practices described, a number of things were true of the individuals at the centre of the securitization process: (1) they were engaged in wrongdoing directly; (2) they were contributing to a culture that did not place sufficient value on risk management and so promoted such wrongdoing; and (3) they were, at least in part, acting on reasons given to them by that culture. It is because a morally objectionable culture can influence outcomes in this way that any individuals who contribute to it can be held to have violated moral obligations, and be held responsible for the outcomes.38 In the case of banks, it is possible to identify a wide range of practices, and groups of individuals engaged in them, that were functionally distinct from the securitization process but that nonetheless exemplified the same failure to value risk management. In this way all these individuals contributed to the culture that inspired the failures at the heart of the crisis, and they too may be held morally responsible.

Take the practices by which Barclays sold payment protection insurance (PPI) to its customers between the early 1990s and late 2000s. In his report on Barclays’ business practices, Salz provides evidence for how the misselling of PPI, driven by a value set that prioritized short-term financial rewards over the protection of customer interests, implicates individuals in multiple functions and through all levels of the organization: from the Group Executive Committee who were aware early on of potential problems both in product


38. It may appear here that my argument is circular, that it depends on individuals both being influenced in their actions by a culture, and also undertaking those actions voluntarily (and in doing so, contributing to that same culture). I accept that both these connections are required for my argument, but just because someone’s actions are influenced by the culture to which she is exposed, this does not entail that she acted involuntarily, or that that action did not serve to reinforce that same culture.
design and sales tactics; to front line sales staff who engaged in those tactics; to the management who oversaw the sales staff; to the legal experts and others who designed the products; to the HR professionals who oversaw the incentivization contracts; and to those working in finance functions who saw how profitable PPI was. By engaging in the practices that together led to accusations of misselling, individuals at Barclays were entering into a joint commitment to value short-term profits above customer interests. More broadly, they were entering into a joint commitment with a wider group both in Barclays and the financial sector as a whole, a commitment to subordinate values such as customer interests and good risk management—values they were under a duty to promote—to the overriding value of short-term profit. Given that the existence of this joint commitment was causally important to the wrongdoing that led to the crisis, causal responsibility is grounded for all those who were party to it.

Returning to the review of the structured finance deal, a third link in the securitization chain was occupied by insurance companies, such as AIG, or niche “monoline” companies like Ambac and MBIA. These institutions offered products that would pay out in the event of defaults or certain levels of default on the loans upon which the securities were based. In doing so they enabled the securities to achieve higher credit ratings, and also guaranteed some of the risk that was to remain on bank balance sheets. Simon Johnson, a former chief economist of the IMF, argues that they were essentially “selling underpriced insurance on complex, poorly understood securities,” a strategy which he describes as “picking up nickels in front of a steamroller.” While such insurance companies were hit very hard by the crisis, when it comes to identifying evidence that the importance of risk management was subordinated to the desire to generate short-term profits, one aspect of their role in the securitization process stands out. When issuing insurance, it is important not just to understand the risks associated with each particular product or policy insured; it is also extremely important to understand when the risk of having to pay out on one product is positively correlated with the risk of having to pay out on others. For example, it is likely to be the case that when one set of loans supporting a security offering is seeing increasing defaults this is for reasons that make it likely that other pools of loans will also see increasing defaults—perhaps because interest rates have gone up.

Subprime lending in the United States quickly increased from virtually zero to very significant levels prior to the crisis; importantly, insurance companies quickly gained large exposure to such loans. However, they had virtually no data available to allow them to assess how correlated the default risk was across all subprime lending. Rather than take the prudent option of limiting

39. Salz, Salz Review, 56–58. For a more detailed discussion of these practices in the context of the argument presented here, see Dempsey, “Moral Responsibility, Shared Values, and Corporate Culture.”

exposure to these loans until better data were available, the insurance companies jumped into the market with two feet, basing their correlation assumptions on existing data for other kinds of residential lending in the United States. As it turned out, correlation on subprime lending was much greater than their assumptions allowed, and the willingness to take largely unknown risks in pursuit of more immediate profit from the securities production line led them to the brink of collapse. It was the threat of AIG’s default in the midst of the crisis that sent global markets, already panicking, into tailspin. A final important link in the securitization chain was that provided by the credit rating agencies. Without the approval of these institutions no securitization deal could have happened at all, as it is only with an official rating that such financial products can be bought by the kinds of investors targeted. In defense of these agencies it is important to note that the ratings they award are only intended to reflect the credit risk of products, in other words the risk of default. They are not intended to reflect liquidity risk in the market for those products, or the risk that market prices will collapse. Moreover, although the market for the kinds of structured securities I have described did dry up and prices collapsed during the worst of the crisis, in many cases the underlying loans did not show defaults significantly above the level predicted. However, this acknowledgment does not mean that the ratings agencies did not participate in the culture that put good risk management to one side in favor of short-term profits. Indeed, just as insurance companies were asked to insure securities based on subprime loans for which there was little data, the agencies were asked to rate them. Asked to make the same choice between caution on the basis of little evidence, or going along with the wishes of the banks originating the securities (and earning large fees in the process), the ratings agencies chose to rate in line with the banks’ wishes. As it turned out, many of the securities based on subprime loans were significantly overrated. 41

7. MORAL RESPONSIBILITY FOR THE CRISIS

This narrative provides evidence that the financial crisis was brought about, in significant part, by wrongdoing on the part of those engaged in the originate-to-distribute funding model who subordinated the value of good risk management to the pursuit of profits and bonuses. It also provides evidence that this wrongdoing was driven by a culture in the financial sector more broadly that endorsed this value set and gave individuals reasons to act in line with it. This in turn grounds causal responsibility for the wrongdoing—and the crisis that followed—for all those financial sector employees whose practices

and behaviors bound them in the joint commitments that established this culture. More needs to be said, however, if we want to go further and ascribe moral responsibility to all these individuals. In this section I make this extra step by arguing (1) that these individuals possessed—or should have possessed—sufficient knowledge to ground their moral responsibility for contributing to the wrongdoing in question and, indirectly, their moral responsibility for the crisis itself; and (2) that common ways of justifying or excusing such behavior do not generally work in cases such as this.

To start with (a): undoubtedly for any individual working in a large, modern business organization there is much about that organization and its operations of which they are ignorant, and this tends to become more the case the more junior that person is. The question is whether the normal level of ignorance of a typical employee is sufficient to enable him to avoid moral responsibility for wrongdoing to which he contributes by engaging in value-laden practice and behaviors which, in turn, contribute to a morally unacceptable culture. There is good reason for thinking that it is not. First, it is not generally plausible that such individuals will be ignorant about the nature of the practices and behaviors in which they engage in their day-to-day working lives. The strength of appealing to these modes of working is that they are the things with which individual organization members are most familiar—the mortgage assessor who approves a loan for someone with no secure income; the advisor who recommends PPI to a self-employed customer who would be excluded from claiming; the ratings analyst who develops a rating rationale with a target rating already in mind. These are all examples of practices engaged in by junior staff where the driving values are abundantly clear.

In response it could be argued that it is not the nature of practices of which employees are ignorant, but rather the existence of obligations not to engage in such practices. However, this claim is also implausible. If any group of people is in a position to understand the context in which an organization finds itself, it is the group that populates that organization. Again, take the case of a mortgage assessor. The very nature of the role that he is asked to fulfill, both in his organization and in the broader context of the financial sector and the purpose it promotes, provides clear evidence of the standards in view of which it should be undertaken—standards founded primarily on risk assessment. Even if it were possible to produce empirical evidence to the effect that many such employees were in fact ignorant of these obligations, this would still not provide them with the desired excuse. Ignorance can be culpable as well as nonculpable, and it is incumbent on any employee to take reasonable steps to identify the obligations that they acquire when taking on a role. Given that such evidence is typically available, as the example of the mortgage assessor shows, even the fact of ignorance will be no excuse.

If this shows that individuals who contributed to the culture in the financial sector may be held morally responsible for this contribution, is this
sufficient to ground their moral responsibility for the effects of that culture—
the wrongdoing others undertook as a result of it, and further, the crisis that
followed? My answer is that it is sufficient. It is true that any one individual
engaging in a practice that enforced the dominant culture could not know
exactly how others would be influenced to act under that culture, or what
outcomes would result. However, given that the dominant values of that cul-
ture were antithetical to obligations that the financial sector was under, she
should have expected wrongdoing of some kind to result, and bad outcomes
of some kind to follow. That she is ultimately held responsible for actions
and outcomes she could not entirely predict is, I contend, simply down to
the operation of a degree of moral luck. However, the operation of moral
luck in this way should not be objectionable. Indeed, its operation is implicit
in the kinds of criticism of members of the financial sector with which I
began and which seem so intuitively plausible in the aftermath of the
crisis.

A final way in which financial sector employees may avoid moral respon-
sibility for the crisis is by appealing to further considerations which, despite
what I have argued so far, justify their actions. A first attempt at justification
accepts that in the narrow context of the roles that such employees occupied
in the financial sector their actions can be morally condemned for the reasons
set out above. However, when considered in a broader context, other con-
siderations outweigh those offered by the narrow context alone and so make
their actions morally permissible, all told. These additional considerations relate
to the consequences that employees face when they act in line with, or go
against, the expectations of them within their organization. On the positive
side employees are incentivized to act in certain ways, and financial sector
employees are often highly incentivized. On the negative side, employees who
do not do as expected are at risk of losing their jobs. The benefits to an
employee and her family, and equally the avoidance of severe financial penal-
ties to her and her family (not to mention the social penalties of being
unemployed) are, on this account, sufficient to outweigh the obligations she
is under not to engage in certain practices. It can be added to this that it
is hardly in dispute that financial sector employees were heavily incentivized
in the run-up to the crisis to engage in practices that systematically under-
valued good risk management. I am not going to claim that this justification
fails in all cases. Any particular judgment would have to be made on a case-
by-case basis and take account of the specific harms that an employee or her
family would face.

However, again I think there will be a presumption against this justifica-
tion, and so it cannot be used as a general argument against widespread
moral responsibility for the financial crisis. For a start, it seems strange to
base a justification for engaging in practices that are prima facie morally
wrong on the fact that someone has a lot at stake in the organization that
promotes those practices. In order for this to be the case he has presumably
invested significant time and effort joining and promoting that organization,
and now he is receiving significant personal reward from his association with it. This fact arguably makes him more, not less, susceptible to moral criticism. To be as generous as possible to this argument we might suppose that in many cases it is not the case that it is possible to know what an organization is like—what its practices and culture are like—until significant personal investment has been made in that organization. Even under this charitable assumption it is still possible to ask what obligations such employees are under once the true nature of the organization they have joined becomes apparent. It is clearly not the case that the only options open to them are either to go along with current practices without question, or to refuse to perform their role at all, or to leave the organization. Plenty of less extreme options are possible that aim at stopping or changing the offending practices without the employee putting their livelihood at risk. To the extent that the vast majority of financial sector workers did not actively try to change the practices in their sector, even in ways that involved very little risk to themselves, appeal to this justification for their actions simply rings hollow.

A second strategy for justifying the actions of financial sector employees and absolving them of moral responsibility for the crisis also appeals to the nature of authority in a business organization, but in a very different way. The thought here is that in many situations where formal authority structures are put in place to serve a certain purpose, there is a presumptive obligation on the part of organization members simply to follow the instructions that they are given and not to try to form or act upon personal judgments as to the appropriateness of those instructions. An argument of this kind has been proposed by David Estlund as a way of absolving soldiers of moral responsibility for following orders in the prosecution of an unjust war. However, even allowing that this argument works in the context for which it is intended and its logic can be extended to the case in hand, financial sector employees would still not satisfy the criteria Estlund sets out as necessary to justify their actions. The first criterion is that the commands are issued in pursuit of a justified end where the decision that it is legitimate to pursue the end in this manner has been reached by an epistemically reliable method. Thus, a jailer is permitted—indeed obligated—to jail the man he has reason to think innocent if a guilty verdict has been reached in a fair trial. The second and third criteria set limits on the authority of such epistemically reliable methods in cases where the prescribed course of action is not even close to what would be considered just or acceptable given the conclusion reached by that method, or the conclusion reached by the usually reliable method is not even close to what the stated facts could be thought to justify. This would be the case if, for example, the jury had delivered a guilty verdict in the face of strong evidence to the contrary (and despite deliberating with the best intentions of fulfilling the process properly); or if the man, having been found guilty of theft, was sentenced to be tortured for his crime.

In the case of financial sector employees, in order for their participation in the practices and behaviors described to be justified, it would have to be the case that they were pursuing a justified aim in a way prescribed by an epistemically reliable authority. Moreover, it would also have to be true that there was not strong evidence that the usually reliable authority had “misfired” in its judgment in this case, and therefore that the practices established as a result were unacceptable for other reasons. It should be acknowledged that there was, in the years prior to the crisis, a widespread belief that innovation in the financial sector—for example, use of the originate-to-distribute funding model—had enabled a step change in risk management and that these ways of working were thus promoting the value of good risk management. To be as generous as possible to this line of argument let us accept that this belief was genuine, and also that the combined wisdom of the market counts in this case as a good epistemic authority. Even if all this is true, it cannot be the case that individual employees were justified in engaging in the practices described on the basis of being instructed to do so by authorities within their business organizations. The reason for this is that the particular practices in which those individuals were asked to participate were clearly not acceptable ways in which to pursue a general aim of good risk management—and indeed were antithetical to such an aim for the reasons already set out. Just as a jailer can never legitimately claim to be pursuing justice when carrying out a sentence of torture, a bank employee can never claim to be pursuing good risk management when issuing loans to individuals with no credit history, assets, or income. The same goes for the other specific instances of practices I have discussed that created and supported the culture in the pre-crisis financial sector.

8. CONCLUSION

The aim of my argument has been to justify claims that are at least implicit in much popular commentary on the recent financial crisis that it is not just the leaders of financial sector institutions, but a significant proportion of their members, who are morally responsible for the effects of the crisis. To achieve this I have set out a theoretical framework for justifying ascriptions of moral responsibility in the context of business organizations on the basis of how individuals contribute to organizational culture, and the connection between culture and the harmful outputs of the organization. On this conception, “culture” should be understood as the set of goal-oriented values to which organization members jointly commit themselves. As cultural values will often be the source of normative information to which organization members appeal when deciding how to conduct their duties, such values fundamentally affect outcomes produced. My argument is based on the claims that (1) when such organizational outcomes are harmful; and (2) they are generated in the pursuit of cultural values that organization members are under obligations not to
endorse, the members who have in fact endorsed those values may be held morally responsible for the harms caused.

In applying this framework to the case of the financial crisis I have focused particularly on the value of good risk management and argued that financial sector employees have a number of distinct obligations that require them to pursue this value as a matter of priority. I have then presented evidence to show that there was widespread participation across the financial services sector in joint commitments—instantiated in working practices—that systematically played down the value of good risk management and subordinated it to other values, in particular the value of short-term profits and rewards. Moreover, I have shown how this subordination of good risk management contributed directly to the precipitation of the crisis. This evidence grounds the moral responsibility of financial sector employees for the harm caused by the financial crisis.

In closing it is worth considering what practical consequences follow from this conclusion. While ascriptions of moral responsibility do not necessarily entail that their subjects are liable for sanctions, it is often the case that in fact sanctions are justified. In the case of the financial crisis such a conclusion is strengthened by considering the situations of the parties who have been found responsible—financial sector employees—and those parties who have borne the brunt of the harm caused by the crisis. While financial sector employees are typically well off, both in national and international terms, it is the least well off who have suffered most—for example, savers (especially pensioners); those affected most by real-terms increases in the costs of necessities; those dependent on state benefits for their income; those excluded from access to financial services. In the circumstances, an appealing method of sanction would be to impose financial penalties on those found responsible, and to use the money to alleviate the worst of the suffering generated in the wake of the crisis. Indeed, there is a precedent for such penalties being imposed—in a number of cases the CEOs of large financial sector institutions have foregone annual bonus payments (to which they were at least in principle entitled by the terms of their contracts) in recognition of the harm generated by accepted failings in the ways they have undertaken their roles. In principle, such an approach could be extended across a whole organization that exhibited a morally unacceptable culture linked to the kinds of practices I have described, where employee benefits were systematically reduced and the funds generated reemployed to combat the harm that culture caused. In practice, the time that has elapsed since the crisis began may make it impossible to target those individuals who contributed to the culture that was in place at the time. However, as a general approach to combating corporate wrongdoing, a system that takes seriously the importance of culture and the contribution that each individual makes to the creation and sustaining of that culture would complement the current unrealistic approach that only finds fault with a tiny minority of very senior leaders and lets the vast majority off the moral hook.
The Moral Accountability of the Financial Industry for the Global Financial Crisis

DAVID SILVER

1. INTRODUCTION

In this essay I lay the charge that the financial industry is morally accountable for the global financial crisis (GFC). This is not to absolve others, such as individual persons and businesses from their share of blame; rather, the aim is to locate the possibility of moral accountability for the industry, and the substantive basis for the charge that it is morally accountable for the GFC.

My point is not to demonize finance, which plays a necessary role in the health of any modern economy; rather, it is to properly locate the industry within the realm of moral accountability, and to thereby clear some intellectual obstacles to the industry redeeming itself for any culpability it has for the crisis.

There are three key elements to this study. First, there is the question of the kind of moral assessment an industry—as opposed to an individual person or business—is properly subject to. I have previously argued that corporations can be morally responsible for what they do, and this argument applies with equal force to show that an industry is morally responsible for what it does when it is organized to act collectively through a trade association.1

1. David Silver, “A Strawsonian Defense of Corporate Moral Responsibility,” American Philosophical Quarterly 42, no. 4 (2005): 279–95. I argue here that a corporation can bear responsibility for actions in which someone acted authoritatively on its behalf. When individuals have the authority to speak or act on behalf of the industry, the industry is morally responsible for these actions in the same way that individual corporations are responsible for the actions of their authorized personnel. Industries do vary from more standard business corporations in that there is a much smaller scope for people to act authoritatively on their behalf.

DOI: 10.1111/misp.12085
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As I will demonstrate in this study, however, the financial industry elicits moral blame with respect to the GFC, and only a portion of that blame can be traced back to any organized collective action on the part of the industry. If the bulk of the blame for the crisis is to withstand scrutiny we need an additional way of understanding how an industry can be blameworthy.

To this end I shall argue that an industry can be morally accountable—but not morally responsible—due to its having a moral culture that reflects and influences how its members think about their moral obligations to their stakeholders. (As I will explain below, moral responsibility is a form of moral accountability that requires agency. I argue that an industry can be properly held morally accountable even when it is not organized as an agent.)

In the second part of the study I argue that the financial industry has a standing moral obligation to help limit systemic risk in financial markets. This requires all members of the industry to adhere to a scheme to contain systemic risk in financial markets, and demands that leaders in the industry ensure there is an effective scheme in place.

In the third part of the study I provide evidence of a cultural failure within the industry to honor this obligation, and that this failure materially contributed to the GFC. It is on this basis that I charge that the industry is morally accountable for the crisis.

The reader should note that while the three parts of the article fit together, they also stand on their own. Thus, those who are primarily interested in the cultural failures of the financial industry with respect to the GFC can profitably skip to Parts II and III.

2. PART I: MORAL ACCOUNTABILITY FOR AN INDUSTRY VIA ITS CULTURE

I begin my argument that an industry can be morally accountable with an account of what I mean by an industry, and the basic condition it must meet in order to be properly subject to blame. Next, I explain the method I use to investigate moral responsibility and related concepts. I then use this method to show that an industry can be morally accountable for an event due to actions its members perform that are consistent with its culture and that contribute to the event. I end this part with some remarks on what being morally accountable for an event requires of an industry.

2.1 What Is the Financial Industry?

For the purposes of this article I understand an industry to be a collective of people engaged in a particular kind of business activity. Those people count as members of the industry whether or not they identify as such, and
whether or not they are organized to act collectively. On this understanding, someone is a member of the banking industry if her business life mostly involves providing banking services.

The financial industry will include people whose professional life centers on activities such as commercial and investment banking, stock analysis, bond rating, stock and loan brokering, and asset management. I will not attempt here to sort out the marginal cases of what counts as a relevant activity or who counts as a member of the industry. Instead, I will concentrate on the core examples of bankers, traders, and the accountants and lawyers specializing in structuring financial deals.

On the account I develop, an industry can be held morally accountable only if there is some shared moral culture across different firms. I will give examples throughout the article that illustrate a shared culture among finance professionals prior to the GFC.

In directing attention to the culture of the financial industry my approach differs from Peter French’s focus on “the FinCri mob.” French pioneered work holding that a corporation can be morally responsible due to its having a form of agency. When an industry is not structured as an agent this leaves no room for him to attribute moral responsibility to the industry. This leaves the question of responsibility of individuals in what is, morally speaking, a mob. Hence, French’s focus on the “FinCri Mob.” But this misses how the financial industry is morally assessable because it has a shared culture. Indeed, once a mob has enough structure to have a culture or moral character it has thereby ceased to be a mob, and enters the realm of moral accountability.

### 2.2 The Strawsonian Approach to Moral Responsibility

In this section I refine and extend an argumentative strategy, originally due to P. F. Strawson, to find that an industry can be morally accountable for actions that its members did even when the industry was not organized to act collectively.

Strawson was concerned with the argument that human beings would not be morally responsible if it turned out that determinism was true; however, he rejected the idea that an agent required free will in order to be morally responsible. He argued that close attention to the structure of our

2. This is not the only plausible understanding of what an industry could be. For example, one might take an industry to be a kind of community in which people identify, at least in part, as members, and may feel some affinity with other members even if they are competitors. People may identify as members of the banking community, or see themselves as someone who “works on Wall Street.” My arguments will certainly include those who identify as members of the financial industry, but also some who do not.


attitudes of blame, resentment, guilt and the like—what he calls the reactive attitudes—reveals that they are made appropriate as reactions to the quality of an agent’s will. The idea that they are made appropriate by a reaction to an ultimate origination of an action was a costly error that mistakenly tied moral responsibility with the possession of a radically free will.

Strawson’s approach to the appropriateness of the reactive attitudes is an example of what I call a normatively sensitive approach to metaphysics. The central idea is that it is epistemically and ethically dangerous to start normative inquiries with fixed ideas of which metaphysical categories matter normatively. The superior approach is to start with our lived moral experience and use it to discover the metaphysical categories that undergird them. While it may turn out that there are no coherent categories that make sense of our normative lives, it is a mistake to reject categories that do make sense of them because they do not cohere with an initial idea of what those categories might be.

A normatively sensitive inquiry into the moral assessability of the financial industry begins with the existence of reactive attitudes directed toward it. The Occupy Wall Street movement, for example, blames “Wall Street” for the GFC, or growing social inequality, or other social ills. Others may take pride in the industry and in how it has extended credit to previously economically underserved members of society.

One might hold that the vast majority of these negative and positive attitudes toward the financial industry are fundamentally mistaken. This is because these attitudes are in response to actions taken by members of the financial industry, but who were not authorized to act on behalf of the industry. In such cases, the financial industry does not act. The actions of the members of the industry are morally assessable; but, the financial industry’s actions in these cases are not, precisely because the industry did not act.

I argue here for the possibility of moral accountability for an industry for nonauthoritative actions its members perform. In a series of articles I have argued that there are distinct categories of reactive attitudes, and it is a mistake to assume that what makes one set appropriate is identical to what makes another appropriate. Rather, we should pay close attention to each subset and not mistakenly hold that the attitudes directed toward human individuals—what I call the individual reactive attitudes—set the normative conditions for all the others. This includes the collective reactive attitudes that we direct toward individuals on account of the collectives they belong to, and the corporate reactive attitudes that we direct toward corporations.

Following Strawson’s lead, I have argued that corporations are morally responsible agents despite the fact that they lack free wills, bodies, minds, and intentional states. I have also argued that a member of a collective can

5. I have previously argued that one member of a collective can share responsibility for the actions of other members who have acted authoritatively on its behalf. David Silver, “Collective Responsibility and the Ownership of Actions,” Public Affairs Quarterly 16, no. 3 (2002): 287–304.
share responsibility for the actions of other members of the collective despite the fact that she did not have an individual hand in performing the action.

By embracing a normatively sensitive approach to metaphysics I now argue that it is a mistake to fixate on whether an industry can be morally responsible. If we are concerned about the kinds of moral attitudes, judgments, and emotions we may have with respect to an industry we should not begin with the fixed idea that it is moral responsibility that matters to their justifiability. We should rather begin with our reactive attitudes and then see what metaphysical categories undergird them, and whether we can maintain these attitudes once we understand their underlying structure.

Using this approach I find that the financial industry is morally accountable for actions that its members perform that are consistent with the moral culture of the industry. I can simultaneously blame an industry on account of its morally deficient culture while being fully aware that the industry has not acted. It is an error to think that the justifiability of the reactive attitudes depends on the existence of actions performed on behalf of an agent. The error illegitimately applies the standards of one subset of the reactive attitudes to another that is normatively distinct.

It is thus not necessary that members of an industry be authorized to act on its behalf in order for the industrial reactive attitudes to be appropriate; what matters is that their actions are consonant with its moral culture. To the extent that an industry’s moral culture is deficient, it is morally blame-worthy for actions that its members perform that reflect that deficiency. Given the internal structure of the reactive attitudes we direct toward an industry, it is not relevant that it did not perform the action as an agent; what matters is that the action can be traced back to the moral culture of the industry, and that we can have a moral reaction to the quality of the culture.

Let me explain why I call this an account of accountability rather than one of responsibility. As a conceptual matter moral responsibility is just too strongly connected to agency to say that an industry is responsible for actions that it did not do. But this terminological point carries little moral import. Industries are still morally accountable for actions that can be traced back to their moral cultures even if they did not actually perform them and thus are not technically responsible for them. We can praise or blame them, and close attention to these forms of praise and blame shows they are not made inappropriate because their targets lack agency.

2.3 The Internal Moral Significance of Cultural Responsibility

There is one further matter that should be addressed to complete this defense of accountability for industries without agency. As Strawson observes, there is a moral significance we attach to matters of moral responsibility that cannot be captured with appeals to external factors such as utilitarian or pragmatic concerns. Instead, there is something internal to the reactive attitude that gives them their own moral significance.
This helps explain some of the attraction of the idea that agents need radical free will in order to be morally responsible. This ultimate originator thesis sees the reactive attitudes as being concerned with the moral quality of agents insofar as they are the ultimate originators of actions. There is a majesty in the possession of radical free will that would seemingly account for the importance we attach to the reactive attitudes; whatever possesses this radical creativity must matter a great deal in the normative world.

Strawson provides an alternative—and I believe superior—account of the normative significance of the reactive attitudes. He holds that they are justified as a reaction to the moral quality of an agent’s will. If the will is disposed to do good then it is morally admirable, and if it is disposed to do bad then it is morally blameworthy. On this account the reactive attitudes matter whether or not the agent in question possesses a radically free will.

I have previously argued for two different extensions of Strawson’s view of the internal significance of the reactive attitudes. First, I argued that the reactive attitudes are made appropriate in virtue of the fact that their targets own (in some robust sense) the actions in question. I call this the ownership thesis.

Second, I have argued that the internal moral significance of the reactive attitudes is accounted for as reactions to the quality of the moral disposition of their target, where a moral disposition governs thinking about the appropriate way to treat persons (and other things of value). In individual moral responsibility we react to the character of an individual. In corporate moral responsibility we react to the culture of a corporation insofar it affects how corporate personnel think it is appropriate to reason about the way to treat persons. I call this the moral disposition thesis.

The moral disposition thesis extends in a direct way to account for the internal moral significance of the reactive attitudes we direct toward industries. It is morally intelligible to direct reactive attitudes toward an industry insofar as we are reacting to the moral quality of its culture.

According to the ownership thesis agents bear moral responsibility for actions that they own. I would broaden this thesis so that an entity is morally accountable for the actions it owns, where responsibility is a major form of accountability.

The ownership thesis is compatible with a wide range of kinds of ownership of actions. In order to be personally morally responsible individuals may need to contribute to the action in some way. This includes being the sole author of the action, or by participating in a joint action.

Members of a collective come to share ownership of a collective’s action by being a member. I can sensibly say that “We did this,” even though I was not personally present and made no direct contribution. (As an American,
I can without dissonance claim that “we declared independence in 1776” without thinking that I personally contributed to the declaration.)

Corporations come to own activities in virtue of authoritative actions on their behalf. Indeed, this is what it is to have the authority to act for another. But this kind of authority is precisely what is absent in the reactive attitudes directed toward industries that I am focusing on.

Can an industry “own” an action when it is not organized to act collectively? I suggest that it can. If the industry’s culture leads people to reason about how to treat persons, then the industry has acquired “culture ownership” of their actions. If the culture-based reasoning of the financial industry helped bring about the GFC, then the industry has “culture ownership” for it. It then is morally accountable for the crisis.

2.4 Moral Implications of Moral Accountability

What are the moral implications of an industry being morally accountable for an action? One implication is its being properly subject to reactive attitudes on account of the action. The industry itself as a collective is subject to moral praise and blame. The moral accountability spreads to members of the industry so that they are subject to praise and blame. It is appropriate for them to feel a kind of guilt or moral pride for “what we have done” or “what we have failed to do.” A member can properly feel guilt on account of how the industry has accorded itself, and not merely shame.

Moral accountability also demands a moral response on the part of the industry and its members. This can include an acknowledgment of accountability as an industry, an apology, and the mending of ways.

Finally, let me be clear that the collective blame directed to members of an industry should be carefully separated from personal blame toward individuals. One can be liable to both, or one can be personally blameless but still blameworthy as a member of the industry. It is fair to ask members of an industry to bear some cost to deal with industry accountability even when they are personally blameless.

3. PART II: THE OBLIGATION TO CONTAIN SYSTEMIC RISK

On the account I developed above, the charge that the financial industry is morally accountable for the GFC requires that

(i) the industry has a moral obligation,
(ii) the culture of the industry fails to respect that obligation, and

8. This account of industry moral accountability is actually an argument for “collective accountability.” This opens up the possibility of, say, moral accountability of the American people for slavery and segregation that goes beyond responsibility for authoritative actions taken on behalf the people. An original sin of the American people has been the pervasive attitude of racial superiority. This can provide the basis of collective accountability on the part of the American people.
members of the industry acted in a way that reflects the cultural deficiency, and which materially contributed to the GFC.

In this section I argue that the financial industry and its members share an obligation to adhere to a solution to the problem of systemic risk. The first step in this argument is to demonstrate the deep, widespread moral costs of breakdowns in the financial system. This can be seen during and in the aftermath of the present crisis, and also in many other crises spread throughout the history of capitalism.

I presume here that there are ways for the financial industry to perform its vital economic role while making financial crises less frequent, smaller, and easier to recover from. Indeed, a simple way to do this would be to refrain from the kind of activities highlighted in Part III. Given the moral costs that can be avoided, I maintain that the industry is morally required to participate in one of these schemes for limiting systemic risk to the financial markets.

3.1 The Financial Industry’s Obligation to Contain Systemic Risk

Moral Costs of Systemic Failures in Financial Markets

In cataloging the moral costs of breakdowns in financial markets I focus on the particular setbacks to particular kinds of individuals with respect to how they are able to live meaningful, self-directed lives. This stands in contrast to an approach that simply looks at the aggregate utility of everyone affected, or on economic effects.

The operation of many businesses depends on a steady and predictable supply of credit. Well-run businesses have plans to deal with temporary setbacks, and changing credit environments; however, the disruption of the entire credit system can put well-run companies out of business. This negatively affects stock and bondholders, managers, employees, suppliers, customers, and other stakeholders.

This has an immediate effect on employees who lose their jobs. This can lead not only to financial disruption but also to bankruptcy and impoverishment if they cannot find new jobs in a reasonable period of time. People should, to the extent they are able, plan for occasional and temporary periods of unemployment. But the widespread fracturing of the economy can jeopardize the financial lives even of people who have set aside prudent reserves. As overall unemployment grows and remains high, there are persistent

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9. Although I will not expand on it here, my understanding of what counts as a moral cost is informed by my general embrace of contractualist moral theory. This understanding of contractualism draws from Rahul Kumar’s *individual reasons* restriction: “Principles in virtue of which an act is judged wrong are to be defended, on this view, by appeal to considerations that have to do with the importance for an individual of its being impermissible to relate to another in this way” (281). Rahul Kumar, “Defending the Moral Moderate: Contractualism and Common Sense,” *Philosophy and Public Affairs* 28, no. 4 (1999): 275–309.
negative effects on the lives of people who are either unemployed or underemployed. This can include long-term effects on health.10

People who keep their jobs live under the increased insecurity and dependence on the particular job that they have. The credibility of the threat of leaving their job for another one is greatly diminished, which can lead to downward pressure on wages and working conditions. This downward pressure can further a deflationary spiral which makes it harder to pull out of the initial crisis. Moreover, there are knock-on social and political consequences of economic depression such as racism and xenophobia. Radical political disruptions are also made more likely in periods of economic dislocation and insecurity.

Another set of individuals affected by the crisis are people who are left with large debts on depreciating assets. It also includes customers who were sold financial products unaware (sometimes fraudulently so) of the financial risk they were taking on. They are left with the painful choice of declaring bankruptcy, and paying off the debt with payments that are often crushing.

At the most general level almost everyone is negatively affected by a crash in the financial system. Each person has an interest in being able to plan his or her life against a reasonably secure and predictable economic background. There will always be ups and downs in markets, and people should make life plans with this in mind; however, it is this interest in having a reasonably secure and predictable economic background that explains why it is wrong to arbitrarily make markets more prone to systemic failure.

Given these deep moral costs there is a moral imperative on those whose actions affect the stability of the financial system to adhere to a scheme to limit systemic risk. If there is a way to contain this risk while still allowing the financial industry to perform its vital role in the economy then there is decisive moral reason to adopt one of those ways.

This obligation exists whether or not there are laws governing systemic risk in financial markets. Indeed, the financial industry voluntarily organized schemes to limit systemic risk before this became a legal concern.11 When such laws are in place, though, they solve the coordination problem of which scheme to follow; and if such laws plausibly do limit systemic risk, then it dictates how the industry should coordinate its behavior.

This is not only due to the coordinating power of the law. Different schemes to limit systemic risk will spread benefits and burdens differently. The question of how to limit systemic risk is thus a political decision that should be determined equitably; and once a democratic citizenry has endorsed a particular decision they should be respected as the segment in society with the legitimacy to make contentious political choices.


To sum up, the financial industry has an obligation to follow laws governing systemic risk (1) as a solution to the problem of coordination on a scheme to limit systemic risk, (2) that is determined via an equitable political process, and (3) which was chosen by citizens who have the legitimacy to make decisions regarding social policies.

Given this obligation, the culture of the financial industry can be judged according to how it guides its members to think about, and act with respect to, systemic risk. To the extent it encourages compliance with existing schemes and promotes leadership to improve them the industry is praiseworthy. To the extent that it fosters indifference or disdain for compliance, or encourages self-serving leadership, the industry is blameworthy; and if the indifference and disdain for compliance on the part of members of the industry lead to a financial crisis, the industry will thereby be morally accountable for it.

Note that the obligation to adhere to a scheme to limit systemic risk is incumbent on everyone who interacts with the financial industry, or otherwise affects the stability of the financial system. In this study I focus on the obligations and behaviors of members of the financial industry.

The Problem of Collective Moral Action

The boom/bust cycle of credit markets throughout the history of capitalism demonstrates that financial markets are prone to systemic risk. In this volume (see essay 2), Seumas Miller explains this cycle as a result of a collective action problem: banks have an incentive to “profligacy” in boom times and “probity” during busts. I shall call these instead “profligacy” and “austerity.”

In the boom cycle each financial actor has incentive to take on great risk, because they benefit greatly if the bet pays off, but the costs of failure can be shifted to others, or perhaps even socialized. If a critical mass of the financial industry takes on sufficiently great risks, the financial system is in danger of a systemic breakdown.

While boom-time profligacy makes the credit system fragile and unsustainable, bust-time austerity accelerates the downfall and makes recovery slow and difficult. Following their individual incentives, the behavior of banks is thus procyclical toward systemic bank failures and then sustained economic depression.

This is not a standard collective action problem in which all actors prefer a world where systemic risk is contained to one where it is not. Some actors might prefer the outcome in which they profit from the boom/bust cycle to the outcome in which the economic system hums along and they make more modest sums. Indeed, one could even rank the former outcome highest, as it is there that they would enjoy the greatest financial and social advantage over others in society.

Regardless of the individual preferences of the members of the financial industry, they each have a moral obligation to try to avoid systemic bank failures. It is thus a problem of collective moral action in which all
have a moral obligation to help avoid the boom/bust cycle, even if they would profit more by its existence. This is comparable to the case in which all people with sufficient means have a duty to contribute to a charitable scheme that takes care of society’s most needy and vulnerable. Not everyone prefers to act on such a duty, but each has the moral obligation to do so.

The collective moral action problem can arise even when everyone would prefer to carry out his or her moral duties. This is because individual firms—even quite large ones—often cannot smooth out the boom/bust cycle through their own commitment to prudent lending. In boom times there will be constant competitive pressure toward profligacy, and firms will often be faced with the choice of engaging in profligate lending or maintaining prudent standards. In remaining prudent, however, they can be both uncompetitive and ineffective at stopping the profligate trend. As they cannot avert the morally bad outcome, the decision to remain competitive dominates.

Given this dynamic, members of the financial industry have an obligation to participate in a solution to the problem of systemic risk should one present itself. This is comparable to individuals in the Hobbesian state of Nature. In a standard understanding, each person prefers not to have the war of all against all, but individually each is powerless to do anything to avert it. Should the opportunity to leave the State of Nature present itself, though, each would have a prudential obligation to participate in it. To strengthen the analogy, note that some individuals may prefer the State of Nature to civil society. They may cherish the opportunity for glory, or the ability to dominate others. But even then they would have a moral obligation to participate in the scheme to leave the State of Nature, given the terrible effects it has for other people.

Likewise, firms and individuals in the financial industry who have the capacity for leadership have an obligation to sustain and strengthen a culture of compliance to a properly functioning scheme to contain systemic risk.

4. PART III: THE FINANCIAL INDUSTRY’S ATTITUDES TOWARD OBLIGATIONS TO CONTAIN SYSTEMIC RISK

4.1 Evidence of Cultural Deficiency

Different kinds of evidence can support a charge of cultural failure on the part of an industry. For example, one could find deficient norms that are shared across the industry. This investigation would go beyond what members of the industry say is the appropriate way to act to see what behavior is actually approved or disapproved, rewarded or punished. It would uncover the understandings of what counts as success or failure for individuals and businesses within the industry. It also includes the shared approval or disapproval of actions by members of the industry.
Further research would reveal whether these shared norms were indications of broader attitudes in society. There would be evidence of a cultural failure of the industry if one could identify deficient norms that were transmitted specifically between individuals and firms of the industry, or through a shared professional education or training.

Along with this investigation into norms, one could look at the actions of both individual and firm leaders within the industry, as well as the actions of the rank and file. This would look not only for widespread behavior that precipitated the crisis but also what actions industry members took to distance themselves from the bad behavior of others, and what actions they took to fix problems within the industry.

I shall focus here on widespread actions within the financial industry as indications of a cultural deficiency that made the financial system more fragile and created the conditions for the GFC. The examples below show how decision makers within the industry sought (1) to get around existing regulations for containing systemic risk, (2) to operate outside the regulatory framework altogether, and (3) to weaken the existing regulatory framework which at that moment needed strengthening. Together this provides evidence of a cultural failure to respect the industry’s obligation to sustain and to adhere to an effective scheme to contain systemic risk.

The first examples concern actions taken to get around capital reserve requirements. The second concerns the use of credit default swaps (CDSs), and how the industry systematically avoided and prevented their being regulated. The third concerns industry efforts to repeal the Glass-Steagall barriers between commercial and investment banking.

I don’t mean to suggest that the failure to respect obligations to contain systemic risk was the only cultural deficiency within the financial industry in the lead-up to the GFC. In reading *The Big Short*, Michael Lewis’s journalistic narrative of the GFC, I am struck by how many high-level traders and investors failed to understand the details and risk structure of the financial products they were dealing in, and by their lack of concern of how their financial dealings might affect the broader society.¹²

Moreover, I am struck by how widespread the tendency was to see customers purely as sources of profits. This includes selling mortgages to people who could not afford them except in the rosiest of economic scenarios. Many of these people were both financially unsophisticated, and encouraged by the industry to take on large debts. Parts of the industry also offered financial products that had attractive teaser rates that soon ballooned into unaffordability. This same attitude carried through to institutional customers of more complex financial instruments. Although these customers were supposedly sophisticated, they relied on compromised bond ratings, and did not understand their true risk. Those sellers who did understand the risk but withheld that information from buyers were essentially engaging in fraud.

These sellers shared a widespread attitude among financial professionals toward their own firms and stockholders. They held an “I’ll be gone, you’ll be gone” attitude toward their own activities. The economy might suffer, and the firm might be destroyed, but the people making the deals would leave and stay rich.

These other cultural deficiencies are morally significant because of the way in which they treat customers and other stakeholders. They are also morally significant because they contribute to the financial industry’s failure to contain systemic risk. The financial industry cannot successfully adhere to an effective scheme to contain systemic risk if it does not pay attention to the risk structure of their products or if it peddles financial products to customers who do not understand the risk they are taking on. In particular, it cannot adhere to an effective scheme if key members of the industry understand the systemic risk they are creating, and take that as an opportunity to personally profit.

4.2 Capital Reserve Requirements and Contempt for Regulations

Capital reserve requirements require banks to maintain capital for a certain percentage of their outstanding loans. One of their functions is to place brakes on the profligacy stage of the boom/bust cycle. The higher the requirement, the less banks have available to loan. Finding the middle ground between profligacy and austerity in bank lending is a delicate art.

Capital reserves also provide individual banks, and collectively the entire credit system, a cushion to survive downturns in financial markets. They allow banks to remain solvent in the event that their loan portfolios lose substantial value. Without adequate levels of capital reserves, a substantial drop in the value of a bank’s loan portfolio would leave it with inadequate levels of cash to pay depositors and force it to sell its assets at just the time that many other banks were forced to do so as well. This creates a downward spiral that can undermine the entire credit system.

Capital reserves have long played a key role in regulatory schemes to contain financial risk.13 I will now look at two widespread efforts to get around capital reserve requirements in ways that contributed to the GFC.

4.3 Use of Special Purpose Vehicles to Evade Capital Reserve Requirements

In the run-up to the GFC many financial institutions discovered ways to make loans while holding capital reserves well below levels in keeping with regulatory requirements.

One mechanism for skirting capital reserve requirements was the collateralized debt obligation (CDO). This is a variation in the traditional

mortgage backed security (MBS) in which banks sell mortgages to financial institutions that would bundle them together and issue a new security. 14

A traditional MBS was issued by government-sponsored entities like Fannie Mae and Freddie Mac. Their mission was to buy up mortgages, thereby providing local banks capital to make new loans. 15 They would then package together these loans as MBSs that they would then sell on the open market.

When an originating local bank sold off a loan it was then able to make a new loan to someone else. However, the capital reserve requirement did not simply disappear. Whenever a bank bought a MBS it would have to maintain its own required level of capital reserves. This meant that as long as the mortgage was outstanding some institution had to maintain capital reserves for it.

CDOs have a different legal structure from traditional MBSs that allows them to avoid the capital reserve requirements on their underlying loans. To avoid these reserve requirements the sponsors of the CDO transfer a bundle of mortgages to a special purpose vehicle (SPV) that is incorporated in a “regulation haven” such as the Cayman Islands. 16

Because the Cayman Islands did not require its corporations to maintain capital reserves for loans held in their portfolios, the use of SPVs allowed sponsoring companies to make their capital reserve requirements disappear. Legally speaking, the sponsoring corporation did not own any loans—it merely “sponsored” the SPV—and thus did not have to maintain any capital reserves. The SPV in the Cayman Islands did own the loans but was not legally required to maintain any capital reserves for them. 17

While this lack of “skin in the game” encouraged profligate lending practices, sponsoring banks were still exposed to risk. When the loans failed they had to choose between rescuing the SPVs, and suffering a reputational

14. A CDO also differs from a traditional MBS in that a CDO can have all sorts of financial products besides mortgages stand as its underlying assets. For example, corporate bonds or even MBSs themselves can serve in this role.

15. Fannie Mae, formally the Federal National Mortgage Association, was founded in 1938 and privatized in 1968. Freddie Mac, formally the Federal Home Loan Mortgage Corporation, was established in 1970 to serve as a private competitor to Fannie Mae.

16. This is sometimes also called a special purpose entity (SPE).

17. See R. W. Kolb, The Financial Crisis of Our Time (New York: Oxford University Press, 2011); SPVs “can be extremely useful in helping a parent company reduce the capital requirements mandated by regulators. The SPV is created as an independent firm outside the scope of regulatory authority. For example, the SPV might be incorporated in the Cayman Islands” (173). “In essence, the idea is that the sponsoring firm can use the SPV to hold assets outside of the purview of its regulators so it will not have to maintain capital against the assets in the SPV. It is generally recognized that using SPVs can be a way of circumventing regulation—a kind of ‘regulatory arbitrage’ in which the capital position of the parent can appear better from a regulator perspective than it is in fact…. Rather than defrauding investors, the idea of SIVs, SPVs and SPEs in the financial crisis was to collude with investors to circumvent regulatory capital requirements” (174).
loss that would prevent them from raising funds in the future. As R. W. Kolb reports,

In the financial crisis, firms with troubled SPVs did indeed bring the SPVs back onto the parent’s balance sheet just as expected.\textsuperscript{18} ... By the time the SPV was rescued, it consisted of large amounts of assets and virtually no equity, so consolidating the SPV back to the parent’s balance sheet made the even greater leverage of the parent more obvious and sometimes forced the parent to attempt to raise new capital. (174)

Banks were additionally exposed to the risk of failing loans as they were often the purchasers of CDOs. They were still required to maintain capital reserves on the CDOs in their portfolios; however, the amount of capital that banks are required to hold in reserve varies with the risk of the underlying asset. As we shall see, the financial industry systematically downplayed and hid the true riskiness of the CDOs.\textsuperscript{19} The net effect is that the level of capital reserves that banks held on their CDOs was well below what their actual risk called for. As CDOs became more and more sophisticated they enabled banks to get more and more highly leveraged. This yielded increasing profits but vastly increased the potential damage that would result from a downturn in the real estate market. This was, of course, the very risk that the capital reserve requirements were intended to prevent.

Those who used this SPV maneuver apparently saw financial regulations simply as challenges to be overcome—without any apparent consideration of their underlying purpose. It would have been better had the banks had more reserves, and had it been more demanding for borrowers to get loans. To the extent that this use of SPVs was an industry-wide practice, the charge that the financial industry is morally accountable for the GFC is borne out.

The financial industry failed in a second way with respect to capital reserve requirements. In 2004 the U.S. Securities and Exchange Commission (SEC) reduced these requirements, largely in response to industry pressure.\textsuperscript{20} The firms involved presumably argued that the industry was prudent enough to determine and hold the appropriate level of reserves. As Kolb puts it, “the SEC seemed to be outsourcing its own regulatory function to its regulatees... For these five major firms, the leverage ratio rose from 22.51 to 30.53 over the 2002–2007 period” (171). He then wryly notes: “Perhaps the industry set some kind of speed record: four years from regulatory relaxation to oblivion” (172–73)

The hubris that the industry showed toward its ability to regulate itself has deep roots; this helped bring on the GFC and all the ensuing moral damage. One of the key ways for the industry to make amends for the GFC

\textsuperscript{18} This practice first came to widespread attention with the Bear Stearns rescue of its two failing hedge funds in 2007. Citigroup also brought massive quantities of assets back onto its balance sheet, as did many other firms caught up in the crisis.

\textsuperscript{19} See Kolb, 166. Obtaining CDS “insurance” for risky bonds allowed institutions to keep lower capital reserves.

\textsuperscript{20} “Indeed, the industry had actively lobbied for the change of rules” (Kolb, 171).
will be to understand that the financial system cannot be protected from systemic risk by leaning heavily on its own wisdom, virtue, and restraint.

4.4 Credit Default Swaps and the Willful Introduction of Systemic Risk

Another way in which sponsors of CDOs increased the amount of risk within the banking system was in the way they sought out higher interest-paying mortgages. Sponsors of CDOs bought risky mortgages that lacked the protections afforded by conforming loans held in traditional MBSs. These protections have included requiring income documentation from borrowers, capping their debt-to-income ratios, and, for most mortgages, requiring a minimum down payment.21

One kind of risky mortgage that was included in CDOs was the so-called “liar loan” for which borrowers did not need to provide reliable documentation of their income. Another set of mortgages did not require a down payment, or even allowed negative down payments where the borrower received cash back on the purchase of her house. Examples like these multiplied and were combined with each other.

The widespread availability of such loans introduced tremendous risk into the financial system. People were obtaining loans that they could only afford in the rosiest of financial scenarios; and, with little or no equity required, the financial system lost one of its most effective cushions against a financial downturn. If a borrower makes a 20 percent down payment, the first 20 percent downturn in the housing market is her problem. If a borrower makes no down payment, the first 20 percent is the bank’s problem.

This raises the question of why banks were willing to lend on these terms (and correlatively how borrowers were able to obtain such mortgages). The short answer is that loan originators sold these mortgages to others. The originator received a fee for selling the loan, but carried none of the risk after the sale.

This in turn raises the question of why individuals and institutions were willing to buy such “toxic” loans. The answer is that these mortgages were bundled together into a CDO, the sponsors of which then “insured” themselves in case of default. I put “insured” in quotes deliberately.

The “insurance” came in the form of credit default swaps (CDSs) from a reputable company like AIG. A CDS is an insurance-like product in which a buyer pays premiums to a seller and the seller is contractually obligated to make a payoff in case of some specified event. AIG sold credit default swaps promising to pay buyers in case of default on CDOs. With this “insurance” in place, morally conflicted and under-resourced bond raters would rate the CDOs far better than their underlying risk merited.22


22. Bond raters failed to discern that the CDS “insurance” was inadequate to merit an AAA rating. They failed in the way that auditors and analysts failed in the case of Enron. Both were facing perverse incentives—give the desired rating, even if they did not fully understand the business, or lose out to competitors who would.
AIG’s business model was to collect fees in exchange for agreeing to “insure” risky investments. In reality it was making a dangerous and risky bet on there being no downturn in the real estate market. As long as there was no downturn AIG and many of its employees did quite well. Once the real estate market faltered, AIG was in no position to hold up its end of the contract. Given the great number of potential defaults on credit default swaps the entire financial system was placed at the brink of collapse. It was only through a massive infusion of public funds that this meltdown was avoided.

AIG’s actions were arguably legal. Nevertheless, it is important to understand how calculated was the decision by members of the financial industry to operate outside the regulatory framework. Indeed, one reason that AIG became a provider of choice for CDSs is that it was not a bank that was required to maintain sufficient capital reserves to pay out in case of a downturn in housing markets. This was a form of regulatory arbitrage akin to incorporating in a regulation-haven country, and just as contemptuous of the underlying need to limit systemic risk.

Importantly, the existence of the arbitrage opportunity was not merely a result of a regulatory agency’s failure to understand the implications of some newfangled financial products. In fact, the SEC and the Commodity Futures Trading Commission (CFTC) had both been vying for regulatory control over CDSs. Congress solved this turf dispute with the Commodity Futures Modernization Act in 2000.

This 262-page piece of legislation was put into an 11,000 page omnibus bill that needed to pass quickly to continue the operation of the federal government. The bill, placed there at the behest of Senator. Phil Gramm, did not receive much scrutiny. One infamous provision that Enron lobbied for exempted the company’s energy trades from government regulation. This unregulated zone allowed Enron to game California’s electricity market, causing dangerous blackouts and brownouts, and costing consumers billions of dollars.

An even more costly provision of the bill was one that mandated that credit default swaps not be regulated at all. Gramm argued that the exemption would “protect financial institutions from overregulation” and “position our financial services industries to be world leaders into the new century.”

23. Fed Chairman Ben Bernanke said that AIG “exploited a huge gap in the regulatory system,” and that “There was no oversight of the financial products division. This was a hedge fund, basically, that was attached to a large and stable insurance company.” See David Stout and Brian Knowlton, “Fed Chief Says Insurance Giant Acted Irresponsibly,” The New York Times, March 3, 2009.

24. AIG was selected precisely because it was not subject to banking regulations. Lewis reports in The Big Short, “There was a natural role for a blue-chip corporation with the highest credit rating to stand in the middle of swaps and long-term options and the other risk-spawning innovations. The traits required of this corporation were that it not be a bank—and thus subject to bank regulation, and the need to reserve capital against risky assets—and that it be willing and able to bury exotic risks on its balance sheet. … AIG just got there first.” 69–70.

25. This quote appears in the July/August 2008 issue of Mother Jones in the article “Foreclosure Phil” by David Corn.
Instead, this lack of regulation would very soon place the entire financial system on the verge of collapse.

So there were several cultural deficiencies on the part of the financial industry with respect to systemic risk. First, there was the contempt for regulation seen in the evasion of capital reserve requirements for “insurance.” Just as banks should maintain capital reserves for loans, insurers should maintain sufficient reserves to be able to pay out for insured events. AIG willfully failed to maintain these reserves, and the companies that purchased CDSs culpably sought their “insurance” outside the regulatory framework that would have required the maintaining of these reserves. Finally, the industry (in part through coordinated and collective efforts) successfully forestalled government oversight of CDSs which, if it had been done well, would have required the issuers of CDSs to maintain adequate reserves to cover insured events.

This reflects not only contempt for the industry’s obligations to avoid systemic risk but also for all the people damaged in the GFC and its aftermath.

### 4.5 The Repeal of Glass-Steagall: A Failure of Leadership

The financial industry not only sought to forestall new regulation but also successfully lobbied for a repeal of the Depression-era firewall between commercial and investment banking. This “Glass-Steagall” provision hived off the commercial banking sector from exposure to risky securities. This not only protected depositors’ funds from a collapse in securities prices, it also protected the banks from their own profligate risk seeking during boom cycles. Finally, it protected the government from having to pay the bank’s bills if the bank became insolvent.

The Glass-Steagall provision was repealed in the Financial Services Modernization Act of 1999, also known as the Graham-Leach-Bliley Act (GLBA). Supporters of the repeal argued that commercial banks should be allowed to deal in securities because they were losing market share to other less regulated financial institutions, and that they would only engage in securities activities that actually served to reduce their risk.

The repeal was urged by the financial services industry, with the newly merged Citicorp and Travelers Insurance leading the charge. The two companies merged in 1998 to form Citigroup. By law, Citigroup had a limited time to comply with Glass-Steagall–type restrictions. The new CEO of Citigroup, Sandy Weill, launched a massive new political effort to repeal the law. According to the news show *Frontline* the finance, insurance, and real estate industries spent more than $200 million on lobbying and made more than $150 million in political donations during the 1997–98 election cycle.  

This amounts to approximately $600,000 in lobbying and political contributions for each one of the United States’ Congressman and Senators. It

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should be noted, however, that the money was directed primarily to members and chairs of committees that oversaw the financial services industry. So the average figure vastly understates the resources spent lobbying on each of a relatively few number of officials.

Although I will not argue this here, I maintain that the way Citigroup and others pushed for their desired legislation was deeply disrespectful of citizens, who deserve a more impartial political process. What I will focus on here is how, on substantive grounds, this political effort was a massive failure on the part of the leadership of the financial industry.

Although the repeal of Glass-Steagall in 1999 marked the time of explosive growth of CDOs and the risky subprime loans that they funded, it would be a mistake to conclude that the repeal of the provision caused the GFC. Indeed, the firewall between commercial and investment banking had largely broken down prior to the repeal through the growth of shadow banking, broad interpretations by regulatory agencies, and regulatory evasion.

For example, Glass-Steagall banned commercial banks from affiliating with companies that were “engaged principally” in securities dealing. Banks would avoid this ban by

Larding up securities businesses with other non-bank businesses before merging them with commercial banks. So let’s say Wells Fargo wanted to buy a hedge fund. It could sell the hedge fund all of its software divisions that handle its information technology, such that more than 50 percent of the fund’s business was software, not securities trading. Then it could safely acquire the fund without running afoul of [Glass-Steagall].

Given tactics such as this the actual repeal of the Glass-Steagall provision may not have made the GFC any more likely.

As Raj Date and Michael Konczal argue, Congress erred by eliminating regulations on banks when they should at that very time have been strengthening regulations on the growing shadow banking sector. They note that prior

27. I have previously argued that corporations may engage in political activity if they respect a number of critical moral boundaries. First, they should limit their political activity such that it does not undermine the ability of citizens to rationally deliberate about public policies that address their interests and serve their values. This means that corporations should not provide false or misleading information in the public realm; and they should respect those institutions and persons—such as public officials, political parties, interest groups, and news media—whose social role is to responsibly present political information to citizens. Second, corporations may not engage in political activities that crowd out or overwhelm other viewpoints from the public arena which are necessary for citizens to hear in order to understand how political choices relate to their own interests and values as well as the interests of their fellow citizens. David Silver, “Business Ethics after Citizens United: A Contractualist Analysis,” Journal of Business Ethics 127 (2015): 385–97.

28. Jonathan Macey, a corporate finance expert who teaches at Yale Law School and School of Management, also explains that the law was rife with loopholes by the time Gramm-Leach-Bliley passed. “By the time we got to Gramm-Leach-Bliley, the Fed … had eviscerated the statute” (Dylan Matthews, Washington Post Blog).

to the passage of GLBA, shadow banks stood at a competitive advantage compared to the regulated bank sector. They could “secure funding at lower cost than commercial banks, while constructing similar asset portfolios.” They could also do so with greater leverage as they weren’t required to keep as large a percentage of capital reserves. As traditionally regulated banks lost profitability and market share,

policymakers had, logically, two broad options: (a) prevent non-banks from encroaching on traditional bank businesses; or (b) allow banks to compete in the markets that were steadily stealing banks’ market share.  

The industry pushed for the second option. In this push for repeal we see several vices on the part of the financial industry. There was the hubris that they were smart and prudent enough only to trade in securities that reduced risk. Second, the commercial banking sector failed to demonstrate leadership at a critical time for the health of the financial system. They saw the rise of the shadow banking system as unfair; but, instead of arguing that the shadow banks be brought under a regulatory system in which they bore their fair share of the costs of managing systemic risks, the commercial banks instead argued that their own regulatory system be relaxed.

4.6 The Regulatory Life Cycle

The repeal of the Glass-Steagall firewall represented an important point in the life cycle of regulatory schemes to contain systemic risk to the financial system. We can mark the beginning of the cycle following a financial crash. When the economy is sufficiently bad for enough people for enough time this can generate adequate political will to regulate financial markets, and adequate will within the industry to accept that regulation.

This was the case during the Great Depression. However, these protections were rendered ineffective through a process I call regulatory erosion. One force for regulatory erosion is the creation of businesses that engage in essentially the same kind of activity that is regulated, but which stands outside the existing regulatory scheme. For example, the development of the CDOs in nonconforming loans created a business that stood outside the traditional regulatory scheme for home mortgages. Conforming loans adhere to affordability metrics and down payment requirements set by GSEs like Fannie Mae. By extending credit to “subprime” borrowers, these CDOs helped push up housing prices for everyone. In doing so they made housing more unaffordable, loans more risky, and the financial system more brittle.

The next phase of the cycle has the regulated industry—say Fannie Mae—complaining that fairness requires that they be allowed to compete on a level playing field; it is accompanied by claims that the industry is smart

enough to handle the weakened regulatory environments. This further weakens the financial system, and helps explain an ensuing crash, should there be one.

And if that crash is painful enough, there can be sufficient political will to enact new legislation, which will in time be subject to regulatory erosion.

Here is a summary of this regulatory cycle:

(i) Unregulated financial activity leads to a boom and then a bust, perhaps repeatedly. This demonstrates that the financial industry is not good, smart, and prudent enough to regulate its own risk.

(ii) In certain political environments, this leads to increased regulation of the financial sector.

(iii) In time, members of the financial industry discover or create unregulated space in which they can engage in business with more profits, but also with more contribution to systemic risk.

(iv) The regulated sector becomes uncompetitive precisely because it is regulated.

(v) The regulated sector successfully pushes for a weakening of regulations in order to institute “fairness.”

(vi) Back to (i).

This regulatory life cycle has occurred frequently. It is not associated only with the banking industry’s push to repeal the Glass-Steagall provisions, and the push by Fannie Mae to reduce the quality of their loans to compete with the shadow banks; in the financial crisis of a prior American generation, savings and loan institutions had a cap on the interest they could pay and were losing market share to new and growing money market funds. The savings and loans pushed for a repeal of their caps so they could compete; but they also had to seek out riskier investments in order to pay the higher interest rates. The collapse of the savings and loans industry was a result of this weakened regulatory environment.

Knowing about this regulatory life cycle should give leaders of the financial industry great pause before pushing for weakened regulations. It is surprising how often, and how quickly, weakened regulations lead to systemic breakdowns in the financial system, with all the attendant moral damage.

4.7 Moral Accountability and the Possibility of Redemption

In this essay I have argued that the financial industry can be morally accountable for actions that its members perform that are consistent with its moral culture. This is so even if the members are not authorized to act on behalf of the industry, and thus even if it did not actually perform the actions that it is accountable for.
While some will reject this account of moral accountability, it contains an important normative truth. The account focuses our attention on that part of an industry’s culture that embodies ways of thinking about persons and other things of value. This focus is worthwhile independent of the account of moral blameworthiness.

I have claimed that the financial industry had a deep cultural flaw that helped usher in the GFC. This cultural flaw merits our attention. The overarching cultural failure was the failure to help contain systemic risk. This failure can also be broken down in terms of more traditional vices. First, there was arrogance on the part of members of the industry—the rules governing systemic risk did not apply to them. Second, there was greed in seeking ways to do business outside the regulatory framework. Third, there was envy on the part of regulated industries of the profitability of the nonregulated sectors. This envy obscured their judgment concerning the proper form of regulation. Fourth, there was hubris that the financial industry is smart, good, and prudent enough not to need regulation. Fifth, there was contempt for the democratic process in which all legislation, including those regulating systemic risk, should be made.

Whatever regulations are adopted in the wake of this crisis, or the next one, they will face the same dynamic of legal evasion and political undermining that the Glass-Steagall Act encountered, and in a far more compressed period. This will happen unless banks and other corporations come to respect their basic moral obligation to help contain systemic risk.

There is a shared obligation on the part of the industry to reform itself so that it honors its obligations to help contain systemic risk—which is really an obligation to all the people in the world connected through the modern economy. This obligation applies to all individuals, and especially leaders of the industry, who have the position and power to affect the necessary cultural changes.

An initial step toward redemption is a good awareness of one’s flaws. This not only puts one on the path to improvement, but also teaches one what bad tendencies one needs to counteract to avoid repeating one’s mistakes. The financial industry needs to reflect on its moral obligation to contain systemic risk (as well as its other moral obligations, including the obligation not to view customers merely as sources of profit). It needs to reflect on how it failed to honor this obligation in the run-up to the GFC. It should then take the possibly painful step of understanding how the culture of the industry needs to change in order to avoid another breakdown of the global financial system.
Moral Culture and the Financial Crisis in Light of the Icelandic Experience

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1. INTRODUCTION

In this article, we ask whether financial crises can be explained by reference to moral culture within the financial industry. We consider the Global Financial Crisis (GFC) that began in 2008 with special reference to Iceland. There, a whole financial system collapsed with serious consequences for an entire society. Every Icelander was affected by the financial collapse; many people lost their personal savings, employment fell, the cost of living rose, debts of the state, businesses, and individuals soared. The financial crisis also had deep effects on Icelandic society, not least in politics, which arguably has not yet recovered. Political mistrust and scandals have led to political instability, with four general elections since 2009 and referenda on different issues.

We take our starting point from an article by David Silver “The Moral Accountability of the Financial Industry for the Global Financial Crisis” (2018, 95) in which he argues that an industry can be held morally accountable due to its having a moral culture. The example of the Icelandic financial crisis serves to demonstrate both the validity of Silver’s analysis of the Global Financial Crisis and the need to place that analysis into a wider context. We argue that examination of culture in this context must include not only the financial system but the culture within public administration, local politics, and local society at large.

We draw on the findings of a Special Investigation Commission (SIC), appointed by the Icelandic Parliament in the wake of the financial collapse in 2008. The mandate of the SIC was “to seek the truth behind the events
leading to, and the causes of, the downfall of the Icelandic banks ... and related events.

The SIC published a massive report in April 2010 containing a detailed narrative of the main events and decisions that contributed to the financial collapse.

The SIC analyzed and assessed these events mainly from the perspectives of law, governance, and economics. A Working Group on Ethics (WGE) collaborated with SIC, evaluated its analyses from a moral perspective, and placed them in a larger context where the financial system influenced local politics, administration, and the social environment (Árnason, Nordal, and Ástgeirsdóttir 2010). The current authors were members of the WGE, which was assigned the task of evaluating whether weaknesses in morality and work practices had contributed to the financial collapse (cf. Árnason 2010).

These reports depict a moral culture to which we will apply Silver’s fruitful analysis of the moral accountability of the financial industry for the Global Financial Crisis. Although it has limitations, the analysis is in keeping with the experiences and findings of the Icelandic investigation. Since we are largely in agreement with Silver, our criticism is not a rejection of his analysis but an attempt to complement it. We argue that the weaknesses of his argument reside mainly in the vague notion of the moral culture of the financial industry and in a failure to explicate the important relationships between the financial industry and the political sphere of society, not least as regards the obligation to contain systemic risk. These relationships can surely vary between different countries, and we tease out some features that were distinctive in the Icelandic case.

In what follows, we examine the notion of moral culture in two stages. First, we argue that the moral culture of the financial industry involves a cluster of different groups with various tasks and different professional duties. In order to assess its moral accountability for the financial crisis, we have to analyze this moral culture in light of the tension that the different obligations of various groups involved may create. The culture of commercial savings and loans institutions was radically different from that of investment banking in the years before the financial crisis; investment bankers had a big appetite for risk. This difference calls for a discussion of professionalism and the sort of professional integrity needed to resist questionable practices and contain systemic risk. Second, we explain the ways in which the Icelandic financial market prior to the collapse facilitated a risk-taking moral culture. Those who were supposed to monitor systemic risk and keep the financial industry in line failed to do so. Furthermore, promises of governmental or state support created moral hazard and escalated risk taking. At the same time, a policy of deregulation was endorsed not only by the financial industry but by politicians, supervisory

1. Icelandic legal act no. 142/2008, article 1.
authorities, and economists. This policy was to be supplemented by increased self-regulation of the financial industry based on moral obligations. At the same time, as revealed by the Icelandic investigation of the financial collapse, there was a pervasive legalistic mentality both within the moral culture of the financial industry and among supervisory authorities. This created a moral void which undermined moral accountability distinct from legal compliance. In conclusion, we argue that both the internal moral culture of Icelandic investment banking and external factors contributed to the financial collapse.

2. A SHARED INTERNAL MORAL CULTURE OF THE FINANCIAL SYSTEM

There are strong reasons for focusing on moral culture in relation to the financial collapse. For one thing, purely individualistic explanations—emphasizing personal vices such as greed, rashness, and bad judgment—seem insufficient by themselves. Admittedly, vices played their part, but we focus on how they are channeled, motivated, and rationalized by a cultural context which provides individuals with incentives and validates opportunities (Silbey 2009; see also Árnason 2015). We examine that culture—in organizations, the financial industry, and the social environment—in order to explain individual actions and decisions more fully.

Silver argues that the financial industry can be morally accountable and blameworthy “due to its having a moral culture that reflects and influences how its members think about their moral obligations to their stakeholders.” Silver also writes, “On the account I develop an industry can be held morally accountable only if there is some shared moral culture across different firms [and] among finance professionals prior to the GFC” (Silver 2018, 97). Two main questions arise in relation to this characterization. First, can it be convincingly argued that the financial industry should be held morally accountable? Second, does the financial industry as a whole have a shared moral culture? Silver devotes a considerable part of his article to arguing for moral accountability, drawing on P. F. Strawson’s approach to moral responsibility. Since the success of that argument is dependent on a coherent notion of a shared moral culture, we will focus on that.

We find it useful in this context to distinguish between internal and external factors of moral culture. Let us first look at the financial culture from internal perspectives. Traditionally, corporate culture focuses on how a corporation influences “its personnel reason about persons and other things of moral value” (Silver 2005, 291). It has been convincingly argued (Klebe Treviño and Brown 2004) that this recognition of the importance of culture places responsibility on the managers of a financial firm to “develop a structure that aims to help [the employees] to do the right thing” (Klebe Treviño and Brown 2004, 78). This emphasis on ethical leadership also

implies that those individuals who are in a position to affect the structure of incentives are more responsible for the culture than others, because they have more power to influence the process and the outcome (cf. Young 2006).

While it makes sense to speak of the moral culture of a particular firm, talk of a moral culture of the financial industry as a whole is less obviously meaningful. Silver deals briefly with the question of what the financial industry is. He writes, “The financial industry will include people whose professional life centers on activities such as commercial and investment banking, stock analysis, bond rating, stock and loan brokering, and asset management. … I will concentrate on the core examples of bankers, traders, and the accountants and lawyers specializing in structuring financial deals” (Silver 2018, 97). This list demonstrates that while the financial industry is “a collective of people engaged in a particular kind of business activity,” it consists of a cluster of different groups with various tasks and different professional obligations which can come into conflict. Therefore, the notion of the financial industry needs to be differentiated and analyzed in light of the tension that these different obligations may create and how they create them. Moreover, as we will discuss in the next section, the internal conflict that can arise from these different obligations requires in addition an account of the relationship of the financial industry with external actors and agencies in the political and administrative sphere which can differ between countries.

Can the different financial professionals mentioned by Silver share a culture? To answer this question, we need to distinguish between a descriptive and a normative account of a shared culture. While different groups can in fact share interests and values, it is questionable whether they should do so in a healthy financial environment. From a moral perspective what needs to be shared in a functional financial culture is the willingness “to do the right thing,” that is, to be committed to ethical behavior (cf. Klebe Treviño and Brown 2004, 70 and 78). But this is not what is implied in Silver’s account of a shared culture because the financial industry would seem to be blameworthy precisely insofar as this ethical core is lacking. However, a shared core willingness to do the right thing does not preclude conflicting views among particular groups on how to interpret and implement it in particular circumstances. In fact, it is a sign of a constructive corporate culture that there is room for different opinions and critical thinking. A pressure for unanimity can indicate that the different groups are united in adopting narrow interests and values or even accepting “unquestioning obedience to authority” which is regarded as particularly damaging (Klebe Treviño and Brown 2004, 74). All the more so if external factors, regulations, political culture, and international system share these values as well, as happened in the case of Iceland.

There are important lessons about internal moral culture to draw from the Icelandic financial collapse. The leaders of the banks saw themselves as individually distinctive, each with a different ethos. In statements quoted in
the SIC report, the bankers describe fierce competition to outperform and grow bigger than the others (Árnason, Nordal, and Ástgeirsdóttir 2010, 88–91). Nevertheless, the description in the report primarily draws a picture of banks with a similar culture, prevailing mentality, and behavior. In Iceland, the culture of investment banking gradually replaced a more traditional, more risk-averse culture of commercial banking. This is in keeping with what happened on the international scene after the repeal of the US Glass-Steagall regulation in 1999. According to a top manager of Landsbanki, the tendency in the Icelandic financial industry was to try to get rid of those who had traditional banking experience and knowledge (Árnason, Nordal, and Ástgeirsdóttir 2010, 191). They did not fit the new mentality of young investment bankers, and there was considerable pressure for conformity. As one of the bank directors of Kaupthing bank said: “It is very hard to change a culture without changing employees” (Árnason, Nordal, and Ástgeirsdóttir 2010, 191). With new owners came a new generation of bankers. The SIC report describes how a small group of business people and bankers ruled a good part of the business sector in Iceland. With a new generation came new practices and behaviors. The younger generation played in the international arena and was ready to take bigger risks than the preceding generation, something that was becoming a trend in international finance. It was a generation focused on success, geared toward short-term profit, especially for the owners and the top managers.

A highly respected senior compliance officer from abroad who worked briefly in one of the Icelandic banks in 2007 described the atmosphere as “cultish.” This implies that there was no room for critical questioning, and a few testimonies in the SIC report substantiate that. This cultish mentality was characterized by the new business model of high-risk investment banking at the cost of traditional culture of commercial banking in Iceland which had mostly been limited to savings and loans. To illustrate this point further, we will discuss two main examples relevant to Silver’s argument. As he writes, there are people in the financial industry “whose professional life centers on activities such as commercial and investment banking.” Silver discusses “the Depression-era firewall in the United States, between commercial and investment banking” (Silver 2018, 112). The main argument for the Glass-Steagall firewall is that it “hived off the commercial banking sector from exposure to risky securities” (Silver 2018, 112) which investment bankers deal in routinely. Under Glass-Steagall, investment banking was permitted but had to be separated from commercial banking where restrictions were required on using depositors’ money for stock market investments. Instead, money was to be invested in growing businesses whose operations could be understood by bankers.

This implied further that the ethos of commercial banking, which is traditionally characterized by prudence and precaution, is radically different from that of high-risk investment banking. This difference creates a tension within the financial culture as a whole, especially when investment banking
imposes its ethos on a conventional loan business. In Iceland, investment banking was almost unheard-of until the end of the twentieth century, when the first steps toward privatization of the banking system were taken and the stock market started to mature. The growing influence of international investment banking explains why bankers who had been socialized in the traditional ethos of commercial banking did not fit into the new culture. The aspiration of banks was to go “beyond normal thinking.”

Also relevant to the Icelandic collapse was a change in the status of regulatory professionals, such as internal auditors, compliance officers, and accountants, on the one hand, compared with, on the other hand, traders. Both regulatory officials and traders are mentioned in Silver’s group of “core examples.” While traders have the explicit task of making a profit and were involved in financial dealings that have been criticized for contributing to systemic risk, compliance officers have the task of ensuring that financial transactions are in line with laws, regulations, and company policies. The two kinds of responsibilities can easily come into conflict. Accountants are a special case as they were paid by the companies whose accounts they certified and were subject to a conflict of interest. They have also been known to engage in creative accounting, the practice of applying metrics to balance sheets that will create the best impression with investors (Jones 2011). Nevertheless, accountants are part of a well defined profession with its own ethos. The different groups have the important role of keeping other groups in check, similar to checks and balances among the state powers. It is a characteristic of a healthy financial system or business that each group is given an opportunity to meet its obligations. But in the case of the Icelandic banks, the powers of internal controllers were weak. There is ample evidence in the SIC report that the role of compliance officers was downplayed or that they were kept out of important decisions (Árnason, Nordal, and Ástgeirsdóttir 2010, 54). One compliance officer described his task in the dominant risk-taking culture as trying to row a small boat against the tow of an oil tanker (Árnason, Nordal, and Ástgeirsdóttir 2010, 51–52).

These examples demonstrate that the notion of a “shared moral culture” can be misleading without important reservations. If it is used to describe a situation where the mentality of one group, that is, investment bankers, prevail in the bank as a whole, and “influences how its members think about their moral obligations to their stakeholders” (Silver 2018, 96), as Silver puts it, then this is what happened in Iceland. On the other hand, we should welcome different cultures both within the financial system to protect against losses, and the banking system needs prudential external regulation to guard against liquidity problems, collapsing share prices, and insufficient capitalization. These internal and external actors work together to prevent systemic risk. It is an empirical question to what extent the mentality of one group in the cluster

4. A video was made by the bank Kaupthing to describe this way of thinking (http://www.dailymotion.com/video/x343bnh)
of groups became dominant within the culture of the financial industry in different countries in the early 2000s. If the mentality of risk-taking investment bankers took over in many places, then groups who we could have expected to provide resistance to the developments due to their professional obligations are responsible in a way the financial industry as a whole is not. External regulators may also have responsibility but not the same responsibility as those involved in a single bank’s system of checks and balances.

Silver points out that “the collective blame directed members of an industry should be carefully separated from personal blame. One can be liable to both collective and personal blame, or one can be personally blameless but still blameworthy as a member of the industry” (Silver 2018, 101). This is an important distinction, but it overlooks the constraints introduced by professionalization. Professionalism is often described in terms of obligations toward the public: “One way of marking a distinction between a job and a profession might be to say that a profession depends on actors adopting ends, and not just acting as if they had those ends for the sake of other incentives. [Professionalism] depends on a commitment—to making a role one’s own and in taking responsibility for upholding not only one’s role but also the integrity of that role” (Williams and Chadwick 2012). This professional integrity can provide the moral ground for resistance against corruption within an industry, made manifest, for example, by a failure to heed the obligation to contain systemic risk. Regulators can play a key role in this task and compliance officers in the Icelandic banks criticized the Financial Supervision Authority (FSA) for not supporting them in their attempt to strengthen their status in the banks (Árnason, Nordal, and Ástgeirsdóttir 2010).

One important question in this context is whether and to what extent all the “people whose professional life” centers on financial activities are professionals in the sense of operating by public-facing and public-protecting shared, ethical codes. In the SIC report, there is some discussion of the role of both internal and external accountants in the banking system, who were found to lean toward the interests of the shareholders or the top management, rather than guarding public interests. As a licensed profession, accountants have important obligations to the public. “Accountants and the accountancy profession exist as a means of public service; the distinction which separates a profession from a mere means of livelihood is that the profession is accountable to standards of the public interest, and beyond the compensation paid by clients” (Love 2008). In line with this, a professor of accounting stated in a testimony to the SIC that the accountant must remember that he or she is “representing the interests of the creditors and the interests of the public, but [is] not just some cloth in the hand of the CEOs” (Árnason, Nordal, and Ástgeirsdóttir 2010, 51). The WGE concluded that deviance from good banking practices was not resisted enough by professionals, and that this was an important factor contributing to the collapse.

If we relate this to Strawson’s approach to moral responsibility, we can say that professional obligations provide a much clearer background for
reactive attitudes than the general obligation of the financial industry to contain systemic risk. Although the members of the public do not expect investment bankers to be “accountable to standards of the public interest,” they do and should expect it of the professions involved in banking. Moreover, there are institutions specifically responsible for systemic risk supervision and regulation. Even though the financial industry is properly subject to reactive attitudes, we need to distinguish between different actors within the financial industry and also take into account that there are others who are subject to these attitudes, such as public institutions which are primarily responsible for the common good. While professional obligations need to be strengthened, this shoring up cannot be carried out unless the financial industry operates within a strong framework supported by regulators and supervisory authorities facilitated by responsible politics. Accordingly, we need to take a closer look at the role of actors outside the financial industry, such as regulators and politicians, whose actions are shaped by the predominant mentality in the general culture of society. But before we do that we will give some background to Iceland’s financial crisis.

3. THE ROLE OF EXTERNAL FACTORS AND THE CULTURAL CONTEXT

There is no simple explanation of the banking crisis in Iceland. To the contrary, it is a combination of political, economic, and ideological factors—not to mention the influences of the international financial market and the concomitant business model which the Icelandic financial system became part of. Nevertheless, important local features also played a significant role. In the process of adjusting to European rules and regulations, two publicly owned banks were privatized during the years 1998–2003. The privatization of the Icelandic banks was largely aimed at loosening the political grip on the banking system where the main political parties had secured strong influence (Kristinsson 1996). In the first phases of the privatization sound principles were laid down, but during the process these principles were relaxed and the privatization ended up as a political deal (Árnason, Nordal, and Ástgeirsdóttir 2010, 19–20). The banks were sold to relatively inexperienced bankers and investors who were favored by the political parties that historically had the most influential presence in the state-owned banks. In that way, the strong ties between politics and finance that were to be severed with privatization were strengthened in a new form. With privatization, the banking system changed from one concentrated in domestic retail banking to one operating internationally and financing acquisitions of businesses in other countries (Zoega 2016).

The growth of the banks was largely possible due to the international financial markets, but Iceland joined the European market in 1993. With easy access to loans at the end of the nineties, consumers entered the housing market and increased spending in all sectors of the Icelandic economy. It was
argued that the Icelandic culture of being small and efficient was the key to this success. In this new environment, everything seemed possible and eventually the size of the financial system of the country was about nine times its gross domestic product. In this aggressive and, as it appeared at the time, successful style, the regulations and best practices of banking were not taken too seriously. Those who urged caution, wanted to slow down, or suggested that the law or regulations were being stretched too far, were looked upon as hindrances and soon either played along or left the business altogether. All these factors are well known parts of the banking crisis all over the world and Iceland was no exception.

Icelanders experienced the consequences of the crisis very powerfully when the three big private banks went bankrupt within a few dramatic days at the beginning of October 2008. Suddenly, the financial industry became evident to the general public as did “the moral cost of systemic failures for the whole society” (Silver 2018, 102). The financial crisis had immediate serious consequences on the Icelandic society with weekly public protests on the streets which finally caused the government to resign at the end of January 2009 (Bernburg 2016). From the perspective of Strawson’s analytical framework of reactive attitudes, it should be noted that the anger of the Icelandic public was directed at the financial industry but certainly no less toward the politicians and the main supervising institutions of the Central Bank and the FSA. In its extensive report, SIC critically analyzed the banking system and business sector but also the role of the administration, the supervisory authorities, policy making, and the politics involved. While the major reason for the fall of the banks was their rapid and excessive growth and their flawed working practices, regulators and politicians were regarded as responsible for neglecting the obligations of protecting the public from the risky behavior of actors within the financial industry. This is clear in the executive summary of the Special Investigation Commission:

The powerlessness of the government and the authorities, when it came to reducing the size of the financial system in time before a financial shock hit, is evident when looking at the history. ... It appears that both the parliament and the government lacked both the power and the courage to set reasonable limits to the financial system. All the energy seems to have been directed at keeping the financial system going. It had grown so large, that it was impossible to risk that even one part of it would collapse.5

The investigations into the causes of the collapse of the Icelandic banks give a picture of banking behavior or banking culture similar to that portrayed by Silver. The SIC report confirmed that the main cause of the collapse was “large-scale and high-risk growth” which was “not compatible with the

long-term interests of solid banks.” Silver argues that the financial industry has a moral obligation to contain systemic risk and discusses various examples of its failure to honor this obligation. This discussion becomes a basis for his charge that the industry is morally accountable for the Global Financial Crisis. Evidence similar to that given by Silver in his account can be found in the SIC report—for instance, there were efforts to get around existing regulations when the banks invested their funds in their own shares and thus deceived both the supervisory authorities and the market about their equity. This is referred to as “weak equity” in the SIC report.

In some cases, the banks operated outside the regulatory framework altogether because of high lending to some groups within each bank or because “the same groups also constituted high-risk exposure in more than one bank.” There is also what the SIC report labels as “cross-financing,” which was the risk that the banks carried from owning each other’s shares. Furthermore, the owners had used the banks for investments in the other enterprises and buying bank shares. This made not only individual banks but also the banking system extremely vulnerable when the financial crisis started. When the system collapsed, each of the three banks had exceeded the 25 percent of its equity by lending to the largest shareholders of the banks, “allowing the shareholders to channel funds into their other firms” (Johnsen 2016, 45). As an example, one of the business groups had borrowed 85 percent of the equity base in Glitnir bank where they owned about 30 percent of the shares. Since the financial crisis, there have been several court cases concerning market manipulation which have revealed in detail the ways in which the banks were used to keep market prices in both the banks and other businesses artificially high.

The investigation of the Icelandic collapse put the relations between the financial sector and politicians under the microscope. For example, it revealed attempts to weaken the regulatory framework. In the SIC report, there is plenty of evidence of the pressure the financial industry put on politicians to relax regulations or to prevent supervisory authorities from doing their job properly. In addition, there are also sad stories of individuals looking for investment advice who were treated “purely as sources of profits” (Silver 2018, 106). And Silver’s description of how “high-level traders and investors failed to understand the details and risk structure of the financial products they were dealing in” (Silver 2018, 106) also fits well with the Icelandic case. This was a culture of short-term growth for individual brokers, managers, and shareholders without concern for the long-term interests of customers and the

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general public. Overall, according to the SIC report, “the concentration of risk of the Icelandic banks” was “dangerously high” and caused the whole system to collapse as soon as one of the banks faced serious troubles.

It is obviously in the long-term interest of financial institutions to contain risk, and failure to do so will eventually lead to crisis. The Icelandic report shows that each bank failed to contain the risk of its own business, ultimately leading to bankruptcy. Regardless of the ownership of the banks, containing risk involves many actors outside banks, including the government, legislators, and other institutions. The state creates the framework and the credit for the financial system. So, it has an influence on its systemic resilience. In other words, it is unclear that individual banks and even the financial industry are able to contain systemic risk on their own. Prior to the collapse, the Icelandic state enjoyed high credit ratings and a healthy surplus from which the banks benefitted. Furthermore, the Icelandic state and the Central Bank had indicated they would offer support if any of the banks experienced liquidity problems. This created a situation of moral hazard, which is “any situation in which one person makes a decision about how much risk to take, while someone else bears the cost if things go badly” (Wolf 1999, 60). There were many signs of such moral hazard in behavior within the banks which was designed to minimize the risk of the providers but placed the burden of the risk on others. Eventually, the high risk for the whole banking system was pushed off onto foreign creditors, customers, and the public at large. Many decisions taken at the top level were aimed at increasing the profit of the few, those who owned or controlled the banks. For instance, salaries and bonuses were awarded for short-term profits, not overall and longer term financial performance. The same narrow and short-term view characterized the international market which, in a time of globalism, it is impossible for individual governments to regulate or limit.

Silver’s examples or “evidence of cultural deficiency” (Silver 2018, 105) mostly deal with regulations or how the industry tried to get around, prevent, or work outside existing regulations. These evasions of the law are legitimized by a political ideology which focuses on deregulation and the rather narrow obligations to shareholders or other special interests (see Friedman 1970). All of this plays a crucial role in the culture that contributed to the Global Financial Crisis. Nevertheless, Silver does not explain how he sees the interplay between the financial industry, regulators, and political policy, or in what way this interplay influences the culture of the financial industry.

Explaining this is no easy task. It can be instructive in this context to consider the interplay between the regulators and the Icelandic banks in the years preceding the financial collapse. The Icelandic FSA adopted a trusting and cooperative attitude toward the managers of the banks, presuming that they were trustworthy because of their long-term financial and reputation-related interests (Árnason, Nordal, and Ástgeirsdóttir 2010, 121). The managers of the banks, on the other hand, advised their employees “to play offensive hardball” against the regulators, for example, on site visits (Árnason, Nordal,
Particular aspects of Icelandic society and culture are relevant in this context. There is a reason to believe that the culture of acquaintance in a small society—one of the distinctive features of Icelandic society—encouraged the trusting approach of the FSA. At the same time, it can be argued that such an attitude would have to build on historical experience of banking culture being worthy of trust. That was certainly not the case in Iceland, where investment banking was a novelty and the bankers were young, with little experience of banking practices. There was no good reason to believe that these inexperienced investment bankers would provide the ethical leadership required to build a trustworthy banking culture (Klebe Treviño and Brown 2004). Nor were there decisive steps taken toward developing a reliable system of self-regulation within the banks, even though that was stated as part of the ideology of deregulation (Árnason, Nordal, and Ástgeirsdóttir 2010). Moreover, in the words of the director of the Icelandic FSA, the prevailing attitude within the banks toward regulation was that it was “just a bloody nuisance and surely everything was allowed that was not strictly forbidden” (Árnason, Nordal, and Ástgeirsdóttir 2010, 117).

The WGE argued that in addition to this contempt for rules and regulations, a prevailing mentality of technical legalism helped to create a moral void in which bad working practices and governance could grow. The defining aspect of technical legalism is that individual articles of the law are interpreted narrowly and in isolation from the main purpose or the spirit of the law. Such legalism often characterized the FSA approach and partly explains the failure to set reasonable limits on the growth of the financial system. A senior economist at the Central Bank of Iceland identified the problem in testimony for the SIC:

> It seems to me that there was a basic misunderstanding about the point of financial regulation here in Iceland. … That it was the role of these authorities to see to it that existing laws were complied with each time. So you are watching the financial system fall off the cliff and, if it is done according to the law, then that’s just fine. (Quoted in Árnason, Nordal, and Ástgeirsdóttir 2010, 124)

Contrary to this attitude, the British Financial Services Authority statement on the nature of regulatory obligations says: “Regulatory and supervisory coverage should follow the principle of economic substance not legal form” (Financial Services Authority 2009, 7).

In line with this sensible attitude of the British Financial Services Authority, Silver argues that while the financial industry has an obligation to follow laws governing systemic risk, the obligation to limit systemic risk “exists whether or not there are laws governing systemic risk in financial markets” (Silver 2018, 103). He also argues that one of the key ways for the financial industry to make amends for the GFC “will be to understand that the financial system cannot be protected from systemic risk by leaning heavily on its own wisdom, virtue, and restraint” (Silver 2018, 110). This is very important and has been
the lesson of previous crises, which show why regulations such as the Glass-Steagall firewall are so badly needed. For this reason, it is highly relevant to discuss the role of regulators, supervisory authorities, and others who analyze the financial market in shaping the culture of the financial industry. As we have seen in the case of Iceland, these actors shared and facilitated technical legalism which supported the attitude within the banks to find ways around laws and regulations (Kvalnes and Nordal 2018).

Even if there was pressure from the financial industry to repeal regulations, regulators have a responsibility to withstand such pressure. And supervisory authorities needed to take a firm stand against manipulation of regulations. Those who were supposed to be critical of the financial industry, who were expected to monitor systemic risk and keep the financial industry in line, failed to do so. The fact is that deregulation was endorsed not only by the financial industry but by politicians, supervisory authorities, and economists as well. This view is in line with the position that the responsibility of business is to maximize the profit of their owners, that is, stockholders (Friedman 1970). The SIC report shows how this narrow view of stakeholders implied that the obligations were primarily to the biggest shareholders. There was no pressure on the financial industry to think of other stakeholders or of the system at large. In a corporate culture where everyone is thinking of growth and profit, there is not much incentive to think of the systemic risk of the industry. Moreover, when the regulators and monitoring agencies also endorse this view, other stakeholders such as customers, the local community, or the public are not represented (Freeman 2012). In this respect, the picture regarding systemic risk is much more complex than portrayed in Silver’s article. This is especially important since the financial system is no ordinary business. No modern society can function without banks—as Iceland realized when their whole banking system was about to collapse. Stricter regulation and limits on the banking system are, therefore, among the important lessons of the financial crisis.

The previous discussion of the Icelandic example shows the importance of looking at external explanatory factors no less than internal factors in the discussion about the role of moral culture in financial industry. It also shows that, in addition to looking for the general features of the culture of the financial industry, the role of particular local factors in shaping the culture needs to be considered as well. What is most relevant in this context is how various factors that characterize Icelandic culture generally may have affected the moral culture of the financial industry in the country. It has been argued that a major reason for the financial collapse was “Icelandic society’s weak business culture, which enabled conditions conducive to corruption” (Vaiman, Sigurjónsson, and Davidson 2011, 259). We have mentioned the lack of respect for rules and technical legalism, lack of professional distance due to tight personal network, and “a symbiosis of business and politics” which enabled bad business practices to thrive (Vaiman, Sigurjónsson, and Davidson 2011, 260).
This shows how features of local culture can influence the moral culture of the financial industry in a particular country. The aforementioned mentality of technical legalism was not a distinctive mark of the financial industry but rather a pervasive feature of the general culture. This relates to the fact that it can be difficult in a small society to maintain respect for laws and rules which can even be regarded as obstacles to creative conduct. The Icelandic cultural heritage was used to demonstrate the “competitive advantage” of the Icelandic bankers: “The ‘Viking ship’ of Icelandic culture is what gives Icelandic business men a competitive advantage: decision-making is fast, lines of communication are short and the pattern of interaction is open, everyone is ready to work hard for a short time as in the fishing season, there is a strong net of relationships and the ‘fixer gene’ flourishes” (Aðalsteinsson and Guðlaugsson 2007, 2). Even the president of Iceland developed his own theory of the unique qualities of the Icelandic bankers, with roots in local conditions and national heritage. “It is an important lesson of history,” he wrote, “that small creative communities can do extraordinary things” (quoted in Gordon 2005). Unfortunately, these “extraordinary things” include the failure of the banking system: relative to the size of the economy, the collapse of the Icelandic banks is the biggest in history (Economist 2008).

Despite serious austerity measures taken on by the government and an IMF program, Iceland’s economy has recovered faster than anticipated, primarily because of thriving tourism, which has gone from less than 500,000 in 2010 to more than two million tourists in 2017. For this reason, Iceland has again experienced steady growth in investment, housing prices going up every year, and low unemployment. Stricter regulations of the financial sector have been put into place, but it still remains to be seen how they and the lessons of the collapse will influence the moral culture of the Icelandic banking practices.

4. CONCLUSION

In this article, we have considered the role of moral culture in accounting for the financial collapse. We have discussed the analysis of the causes of the Icelandic financial collapse and tried to show how it fits with David Silver’s argument about the shared moral culture of the financial industry. Silver makes very important points about the cultural deficiency of the financial industry, a culture that badly needs to be repaired, as the case of the Icelandic collapse demonstrates well. Surely, the financial industry has an important role in repairing their culture but, as we have emphasized, it is a culture of diverse players with different roles and conflicting obligations. Moreover, the financial industry consists of many working parts, possibly with common features that contributed to the financial collapse. The moral culture of the financial industry is very complex and is shaped by the interaction between different groups both within and outside the financial system.
Therefore, the relevance of the shared moral culture cannot be discussed adequately without taking also into account the external factors in each country and international influences. Drawing upon a parliamentary investigation of the Icelandic financial collapse, we have argued that the different roles played by various actors in the financial industry place different obligations on them which affects their responsibility for the course of events. We have shown why there is a need to think about the nature of the professions and their role in resisting both internal and external pressure to deviate from good practices, and also how legal or supervisory frameworks on both national and international levels contribute to healthy financial culture. We have also argued that political decisions and cultural attitudes and mentality, such as technical legalism and national pride, facilitated and legitimized the course of events in the case of Iceland.8

ONLINE SOURCES

A video was made by the bank Kaupthing: http://www.dailymotion.com/video/x343bnh
Icelandic legal act no. 142/2008, article 1.
Summary of the SIC’s Report’s Main Conclusions; see http://www.rna.is/media/skjol/RNAvefKafli2Enska.pdf

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8 We thank Tom Sorell for helpful editorial remarks on earlier versions of this article.


Who’s Responsible? (It’s Complicated.)
Assigning Blame in the Wake of the Financial Crisis
KENDY M. HESS

1. INTRODUCTION

“Who’s responsible for the financial crisis?” Even a preliminary answer will be enormously complicated, of course, but the question itself is more complicated than it seems. The first two words mask important ambiguities that need to be addressed before we can begin the torturous process of answering it.

“Responsible” is ambiguous between causal and moral responsibility, and then again between retrospective and prospective moral responsibility—between the question of who can be blamed for it and who might have an obligation to do something about it going forward. While the two classes surely overlap, it is worth remembering that they need not be co-extensive. Actors who did not contribute to the crisis and actors who are otherwise not to blame for it may still have obligations to address the aftermath or to prevent similar occurrences in the future. Nonetheless, for the purposes of this article I set these complexities aside and—like most of the collective responsibility literature—focus exclusively on retrospective moral responsibility. Who is to blame for the financial crisis?

Looking into the “who” of “who’s responsible” forces us to confront the collective nature of most business practice. First, individual human agents

1. My focus here is exclusively on moral responsibility, and the moral blame and (sometimes) punishment that can follow—criticism, shunning, and the rest. I do not address the question of legal responsibility, which has no formal connection to moral standards of responsibility and blame (pace Hasnas 2012).

DOI: 10.1111/misp.12087
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generally play narrowly defined roles which are carefully integrated with the narrowly defined roles of other individuals to form highly structured organizations. Almost everything they do is part of some larger collective effort, and as a result they (individually) have little knowledge of or control over events; this in turn tends to shield them from blame for those larger events, under traditional moral theories. Second, the organizations themselves are likely to qualify as “corporate agents”—collective moral agents capable of acting in their own right and thus of bearing blame for their own actions. How are we to allocate blame within such a tightly interwoven, heterogeneous mass of agents?

Individualists and collectivists have different mechanisms for allocating blame in collective situations, both of which are problematic in this particular setting. Individualist approaches face difficulties because individual members rarely meet traditional thresholds of knowledge and control. Collectivist approaches avoid that difficulty but are generally inapplicable in this particular context because the members of the relevant financial institutions aren’t unified in the ways required by the theories. Further, both rely on a distributive approach to responsibility with implausible results. I thus turn to holism in Section 3, presenting my own account of corporate agents with its distinctive commitment to forms of agency which draw on the full membership of the corporate agent. This is the approach that allows us to blame the firm itself. Critics have objected that blaming the firm forces us to either blame the individual members for things they haven’t done or to excuse them entirely. Section 4 rejects both claims, first clarifying the relationship between the members and the corporate agent and then drawing attention to a nondistributive paradigm for responsibility which I call “collateral responsibility.” We see this paradigm at play in any situation in which one autonomous agent (X) significantly influences the choices of another (Y) without fully controlling Y or otherwise undermining Y’s autonomy. Y remains directly morally responsible for its own free actions while X is directly responsible for the ways it influenced Y and collaterally responsible for the actions that resulted. Section 5 considers the implications for Countrywide and its members.

2. RESPONSIBILITY IN COLLECTIVE BUSINESS SETTINGS

Retrospective moral responsibility—blameworthiness—is complicated at the best of times. In a business setting, however, complication piles on top of complication until it becomes a seemingly impossible tangle. Broadly speaking, blame for an event (E) requires five elements:

(i) A moral agent (X): only moral agents can bear blame.  

2. For the purposes of this article I will ignore the small businesses that play such a significant role in the contemporary economy. They did not play a significant role in the crisis so I set that nuance aside.

3. But see Björnsson (2014) and Wringe (2010) regarding the possibility that nonagent collectives can bear obligations.
(ii) An action: there is a specific act (ϕ) such that by ϕing, X could have significantly affected the likelihood or severity of E.

(iii) An obligation: X cannot be blameworthy for ϕing if X had no obligation not to ϕ.

(iv) A certain degree of knowledge: X cannot be blameworthy for ϕing if X did not know that ϕing was wrong (or that X was ϕing, or that ϕing related to E).

(v) A certain degree of control: X cannot be blameworthy for ϕing if X was unable to do otherwise. 4

Take the simple event (E) of “Y being slapped.” X is blameworthy (or “to blame”) for E only if (1) X is a moral agent, (2) by ϕing, X could have significantly affected the likelihood or severity of Y being slapped, (3) X had an obligation to ϕ, (4) X knew of the obligation and that X’s action violated/failed to meet it, and (5) X was able to ϕ. Each of these five elements tends to take on a distinctive cast in a business setting.

Least significant here, the obligations are typically more complicated in a business context than in the simple case of X slapping Y. People retain their traditional moral obligations not to lie, cheat, steal, or slap people—when they go to work, but they also take on additional obligations. For example, at work X also has to meet the distinctive ethical/professional standards that apply to her work-related behavior, and additional obligations attached to the roles she occupies at work. Thus X has additional obligations at work that she does not have elsewhere, and a heightened likelihood of facing conflicting demands.

More significant here is the fact that most business activity is “collective” in some way: it is an essentially cooperative activity (however competitive) that requires the coordinated activity of many individuals. This has important implications for both the actions involved and for the knowledge and control of the individual members. Many of the actions that take place in a business setting are collective, larger and more complex than “slapping Y.” Things like bringing a new factory on line, auditing a facility, closing a deal, and insuring a property are not typically done by a single individual. Instead, they involve the disparate, heterogeneous, carefully coordinated efforts of many people. Our ability to coordinate our efforts in these ways allows us to do things that no individual could do alone, but also presents difficulties when it comes to questions of what an individual agent can know or control. The members are full moral agents, with typical amounts of knowledge about their own surroundings and typical levels of control over their own actions, but each is also a regular participant in ongoing projects that extend far beyond those limits. Each occupies an established role with respect to those projects—which may or may not match her official job

4. Each of these elements can be (and has been) contested, and I make no effort here to engage with the extensive literature on blame (Tognazzini and Coates 2016 is a good starting point). I offer this as a generic, broadly accepted starting point for discussion.
description—and her knowledge and control within the organization will generally be limited to what is necessary to fulfill it. This is true even at the higher levels: managers and executives likewise fit themselves into existing roles, and are unlikely to be in a position to know everything that is happening in the organization, or to actually exercise control (v. influence) over what happens there. For those organizations that survive and thrive, all these bits and pieces of incomplete information and limited spheres of control form an interlocking mechanism in which each effectively completes and is completed by others such that the organization itself manages to work effectively toward its goals. Their ability to do so is evidence of effective institutional structures; it is not evidence of a single person with sufficient knowledge and control to direct the behaviors of the members who collectively bring it about.

Finally, there is the matter of the collective projects in which the members participate in piecemeal fashion. Setting aside the case of a start-up, each member of an organization comes to it as a going concern, with practices and priorities and projects already established. Members rarely join such organizations because of personal commitments to the organizational project. Three people moving a couch are moving a couch because they want to move a couch, but people don’t (typically) take jobs at Exxon because they want to be a part of producing petroleum, or at Countrywide because they want to be a part of providing residential mortgages. They take jobs at these and other firms because they need jobs. They need or want the money, power, connections, growth, and so on that come with employment because these allow them to pursue other interests. They thus join these organizations as a means to personal ends, participating in the project of the organization without necessarily adopting it for themselves. They participate in the pursuit of ends that are not their own. So whose ends are they? The most obvious possibility—a possibility only, at this point—is that they belong to the organization itself.

In a business setting, then, with respect to the five elements necessary for blame, we have distinctive sets of obligations. Beyond that, we have distinctively large, collective actions performed by individual agents with distinctively reduced knowledge and control over those actions. The only element remaining is the (also distinctive) moral agent. As noted, the members themselves remain moral agents responsible for their own actions within their own spheres of knowledge and control, but there is (typically) no single member with knowledge of and control over the entire organization. As also noted, the organization itself is typically organized around the pursuit of ends that are not those of its members. The final complexity in many business settings is the possibility that the organization itself—the firm, with its own ends and its encompassing store of information and power—might qualify as a responsible moral agent in its own right.

With that basic introduction to some of the complexities of placing blame in business contexts, I thus turn to the philosophical literatures that have attempted to address such situations. There are three basic approaches
to understanding agency, action, and thus moral responsibility in collective contexts like the one just described: individualist, collectivist, and holist.  

Individualists recognize only (human) individuals, reducing collectives to their members and allegedly “collective” action to its individual components. There was no “mob” that “stormed the Bastille.” There were a number of individual persons (Xs), each of whom performed certain actions (throwing stones, breaking down doors) that are loosely captured under the description “storming the Bastille,” but there was no single entity that “stormed the Bastille”—no agent with the knowledge or control sufficient to perform the action and thus bear responsibility for it. For much the same reasons, the storming of the Bastille may have been an event (something that happened) but it was not an action, in part because—again—there was no agent to perform it. Consequently, there is no agent to be blamed (or praised) for “storming the Bastille” and in fact no act of “storming the Bastille” for which anything could be blamed or praised. Blame associated with this event attaches exclusively to individual Xs, and then only for their individual actions. The Xs who (allegedly) participated in “storming the Bastille” are blameworthy depending on whether they (1) threw stones or not; (2) had an obligation to throw stones or not; (3) knew or should have known that they had this obligation and were participating in this activity of throwing stones; and (4) had sufficient control over whether they did so.

Turning to the financial crisis as a whole, for the individualist there is no one to blame because no human individual had the knowledge or control to bring it about. The financial crisis was an event, but “causing the financial crisis” was not an action for which anyone can be blamed. Instead, according to individualism, there were just individual actors and individual actions that intersected with unfortunate results, and blame will have to attach exclusively to individual Xs depending on whether their own isolated actions violated moral standards. As long as each individual action met appropriate moral standards in its own right, there is no moral violation for which blame could be appropriate; to the extent any individual violated a moral standard then she is to blame for that violation, but not for the larger event to which she only contributed. Lacking knowledge and control over the ways her contributions interacted with those of others to form collective actions, she cannot be blamed for it.

This is one of the primary costs of individualist approaches to moral responsibility (both retrospective and prospective). They generally fail to capture the ways in which the actions of individual agents reliably mesh to form consistent, predictable patterns of activity larger than the agents who participate in them. We recognize and rely on these consistent, predictable patterns every

5. My aim here is simply to provide a quick introductory sketch of individualism and collectivism for those unfamiliar with the field. What follows is thus a bit of caricature, and scholars working in these areas would surely have more to say for their chosen approach, though I believe the ultimate result would not be significantly different. For a more serious engagement with individualism see Ludwig (2017); Narveson (2002); Rönnegard (2015); Velasquez (1983, 2003). For a more serious engagement with collectivism see Bratman (2014); Gilbert (1992, 2006); Miller (2001, 2006).
time we engage with an institutional actor, and it thus seems a little arbitrary to deny their significance or reality when it comes to moral responsibility. But this is the individualist commitment (motivated in part by the concerns addressed at the beginning of Section 4 below).

Collectivists note that the people who stormed the Bastille shared intentions or ends which brought them together, unifying them into something other than the mere aggregate of individuals recognized by the individualist. Because of these shared intentions or ends, they cooperated effectively to achieve something which all desired and none could have accomplished on her own. Collectivists argue that the knowing, voluntary adoption of these intentions or ends makes up for the lack of knowledge and control over the larger project that blocked moral responsibility on the individualist approach. While there are disagreements, collectivists generally recognize properly unified collectives as capable of morally assessable collective actions while still refusing to recognize the collective itself as a full agent capable of full responsibility.

For example, Seumas Miller argues that a group of individuals constitutes a single entity if they share a “collective end,” which is

an end possessed by each of the individuals involved in the joint action … that is not realized by the action of any one of the individuals…. Each agent has this state of affairs as an independent end. (It is also a state of affairs aimed at under more or less the same description by each agent.)

Thus a group of individuals has the collective end of storming the Bastille if each member of the group has that end and aims at it under more or less the same description. The collective end defines the collective, shapes its actions, and personally motivates the members. On Miller’s account, the members of such a group are individually morally responsible for their contributing actions and jointly morally responsible for the resulting state of affairs. This has the effect of blaming each member for the actions of others—each member is to blame for more than just her own actions—and this violates the traditional requirements of knowledge and control. Miller justifies this extra responsibility on the basis of each individual’s knowing, voluntary possession of the collective end that defines the group.

Similarly, Margaret Gilbert argues that groups of individuals can be treated as a single agent because of the way the members are bound to each other—when they have “joint commitments to do something as a body.”

X and Y have a joint commitment to φing when each has independently committed herself to the joint project of φing (as opposed to each being independently committed to φing). For example, they are jointly committed

to storming the Bastille when each has individually committed herself to doing so with the other. This is a conditional, reciprocal commitment, conditioned in part on the other person’s knowledge of its conditional, reciprocal nature. They are jointly committed to the project, and neither may withdraw without the consent of the other.9 On this account, members are properly blamed for the results of collective action because—and when—they intentionally entered into conditional, reciprocal commitments to perform it.10 As with Miller’s approach, this has the effect of blaming each member for the actions of others—each member is to blame for more than just her own actions—and this violates the traditional requirements of knowledge and control. Again, though, the extra responsibility is justified by each individual’s knowing, voluntary choice to adopt the joint commitments that define the collective, shape its actions, and motivate the members. X has committed herself to storming the Bastille, and has made reciprocal commitments with others in order to pursue that project. If storming the Bastille was wrong, then it’s appropriate to blame X for storming it because X wanted to engage in the project of storming the Bastille (jointly, with others) and did in fact play her part in doing so.

The difficulty with using collectivist approaches in connection with large organizations is that large organizations are not defined or unified by such universally, uniformly held ends and attitudes.11 This is to some extent an empirical claim, of course. It is possible that each of the 34,000+ members of Goldman Sachs, or each of the 12,000+ members of Countrywide, did in fact have her own individual commitment to banking (and all of the many other ends that those firms have)—that each wanted to ensure the availability of investments or mortgages, and joined with others in order to pursue that end. Or it is possible that each member was personally motivated by (all) the various ends that Goldman Sachs and Countrywide pursue, and understood and evaluated her daily efforts in terms of how they relate to those ends, feeling personally bound by joint commitments to her co-members. But it seems unlikely. It is far more likely that the members of Goldman Sachs and Countrywide, taken as a whole, are like those at other large enterprises: each goes to work for her own reasons, each does her job as she understands it, and none is especially prone to worry about how her actions mesh with those of other members she has never met, or about which of her firm’s many projects are being furthered by her efforts. The ends toward which Goldman


11. There is a marked tendency in the business literatures to (silently) draw an equivalence between “firms” and their upper management—as if references to “the firm” can be swapped out for references to management and vice versa. Among other difficulties, this has the unfortunate effect of treating lower level members and their actions as a kind of inert extension of the managerial will; I address this briefly in the next section. Here I just want to note that my references to “the firm” are references to the entire firm, the whole membership; it is not a coded reference to the executives or other levels of management.
Sachs or Countrywide are working play no part in her personal motivational set—they are not “a state of affairs at which she aims”—and she feels no particular sense of mutuality or reciprocal obligation towards the thousands of other members that make up the firm.

If this is so, however, then these collectives are not unified by the collective ends required by Miller or the reciprocal joint commitments required by Gilbert. These things may be present within subordinate groups within the firms, especially at higher levels, but the firms themselves are not unified or directed by such things. Lacking them, the firms do not qualify as collectives capable of action and neither the firms nor their members can be blamed on the basis of these accounts—a result that both Miller (2001, 179) and Gilbert (1992, 231) acknowledge as likely. Thus, after all the theoretical gymnastics required by the collectivist theories, we are still left with the unpalatable result that no one is to blame for the financial crisis.

Before proceeding to the holist accounts that will recognize blameworthy actors, I should pause to acknowledge that some “unpalatable” results are nonetheless appropriate. David Rönnegard speaks for many critics of holist approaches when he notes (with a certain amount of exasperation) that sometimes bad things happen that nobody intended and for which nobody is responsible:

How is an unintended event resulting from the actions of the members of a collective morally different from a natural event? For example, what is the difference between a tree falling naturally and killing a man or as a result of several people concertedly trying to fell the tree? Is the fact that the latter is dependent on the actions of people morally relevant? (46)

In a word, yes. Morally speaking, there is an immense difference between “untoward events” that result from the actions of moral agents and those that do not. It is certainly more complicated to assign moral responsibility when large groups of people bring about “untoward events” like the financial crisis (or systematic oppression, or climate change). But the difficulty does not allow us to just shrug our shoulders and chalk it up to fate as we must with (some) earthquakes and meteor strikes.

3. CORPORATE AGENTS

On my account, a corporate agent is a highly structured collective: a group of agents bound together by a “structure” that embodies a “rational point of view.” Typical examples include universities, governments, religious orders, and of course business entities (legally incorporated or not).

The “structure” of a corporate agent is a network of social relationships—internal to that corporate agent and unique to it—which imposes constraints on the actions of the members.12 As the members participate in the

12. This account is drawn directly from Sally Haslanger (2016).
behaviors distinctive of this structure, they conform to templates of interaction that favor certain forms of action and coordination over others and make certain kinds of things available to them (concepts, resources, social relationships, power). Taken together, these templates and incentives essentially “structur[e] the possibility space for agency” while the members are acting as members.13

The structure that unifies a corporate agent is thus immensely complex. It is not limited to formalized elements but incorporates official and unofficial policies and practices, documented and undocumented incentives, and explicit and tacit expectations. The discernible elements will thus include intentionally developed things like official hierarchies, standard operating procedures, and voting practices (formal and informal)—all as enacted—as well as things like Gilbert’s joint intentions and Miller’s collective ends.14 It will also include unintentionally developed, often tacit elements like the real power structure (versus the one on the organization chart), the incentive schemes bound up in culture and peer expectation, and demands embodied in office politics, office culture, and unpublished actual practices. Always multiply (though not indefinitely) interpretable, the corporate structure (at a time) is the culmination of the actions and decisions of dozens (or hundreds, or thousands, or hundreds of thousands) of members over the entire length of the corporate agent’s existence.

More importantly, the structure is not neutral. It embodies a logically coherent set of commitments about fact and value—about how the world is and what matters in it—that reliably guides action, and this provides the corporate agent with a specific, unique orientation to the world. In the remainder of this section I sketch three mechanisms by which a corporate agent (Acme) could generate new commitments that none of its members held or desired. I will return to these examples later, in the discussion of member responsibility. I then close the section by noting the philosophical implications of these otherwise unremarkable observations about corporate function. Before we begin, though, a word of caution: In what follows I repeatedly describe situations in which members unintentionally—and often unknowingly—instantiate new corporate commitments through their actions. I do so to demonstrate that things can happen this way, that there is no necessary linkage—conceptual or causal—between member intent and the corporate commitments and structures that arise from member activity. It is not, however, necessary that the members act unintentionally or unknowingly, or that the corporate commitments established by their actions be inconsistent with their own.


14. Those familiar with the literature will recognize the references to Peter French’s (1984) CID structures, Patricia Werhane’s (1985) systems, and Christian List and Philip Pettit’s (2011) vote aggregation procedures.
3.1 Explicit Decision Making

In the first mechanism, the decision to modify is quite intentional and explicit: some group of ranking executives votes, the majority wins, and the firm adopts a new position. This is the kind of mechanism that French, Werhane, and List and Pettit have in mind, and often involves the development of collective intentions similar to those proposed by Gilbert and Miller. Even in these cases, the resulting position does not necessarily reflect the participating members’ own commitments regarding the issue. For example, Acme’s executives know that Acme is committed to seeking profit, producing industrial chemicals, and being environmentally responsible. Reasoning from these commitments, Acme’s executives could easily conclude (and vote) that Acme ought to produce steel additives. They could also conclude that this should be done in ways that are protective of the environment, but it is clear that Acme’s commitments to profit and production are more central to Acme and take priority. And so Acme develops a new commitment to producing steel additives and the work goes forward, preferably in an environmentally responsible way—not because any executive cares about steel additives (or the environment) but because the new commitment is a logical extension of the existing commitments. Should the commitment to environmental responsibility prove too cumbersome, the executives may well vote to abandon it—or lead Acme to abandon it in practice without even realizing they’ve done so—despite their own personal commitments about the environment. Going forward, Acme’s actions will nonetheless express this altered commitment rather than those of its members.

3.2 Distributed Decision Making

Using a second mechanism, Acme may abandon its commitment to environmental stewardship through a distributed process—one which is much less explicit and often effectively opaque to the members involved. While the first mechanism is more common at executive levels, this one typically occurs in the middle tiers, and the participating members may well be unaware that they are establishing a particular commitment for the corporate agent—one which will nonetheless shape future corporate action. Distributed decision making is a bit like assembling a car, with each member contributing one fact or decision and then passing the project on to the next without any member being in a position to see the corporate commitments that arise as a result of their individual choices, or to anticipate the corporate actions that will follow.

To sketch an unrealistically simplistic example of this second method, assume that as a result of Acme’s new desire to produce steel additives,

15. To make this more realistic, assume that each “member” in the example is a department, add further concerns—and additional steps—to address tax implications, public relations, supplier relationships, and so on, and recognize that the process is unlikely to be quite so “linear” and unidirectional.
Member A requests proposals from departments $\alpha$, $\beta$, and $\gamma$.

Member B picks the proposal from $\alpha$ and modifies it slightly to reduce costs,

Member C modifies the proposal to improve materials handling,

Member D modifies the proposal to improve efficiency,

Member E modifies it to improve health and safety compliance (less worker exposure),

Member F modifies it to use different (domestically available) chemicals, and

Member G modifies it to reduce costs again.

As a result of these piecemeal modifications and others during implementation, each innocuous and rational within its own limited sphere, the new production line results in a continuing discharge that—as it continues unabated over time—pollutes a local river. This new carelessness around environmental impacts is a side effect rather than an intended result, but the effect is the same: Acme has begun to act, consistently, in an environmentally irresponsible manner. As the discharge continues and members slowly become aware of it, it comes to be seen as an accepted practice when in fact it is simply hidden. Later, it becomes an accepted practice, and (consciously or not) the members adjust their own expectations and behavior on the job. And Acme takes another step away from its prior commitment to environmental responsibility.

### 3.3 Cultural Shift

The third mechanism by which Acme can adopt new commitments is even more broadly distributed (and thus even more opaque to the members) and can originate with members at the lowest levels. When processes like the one just described happen repeatedly throughout the firm, Acme becomes a firm that has either lost its prior commitment to environmental stewardship or (more strongly) gained a positive commitment to not practicing environmental stewardship. With that, both old members and (especially) new members coming in will incorporate this new commitment—consciously or not—into their understandings of their jobs. Behavior that conforms to it will be rewarded or at least ignored, and behavior that contradicts it will be greeted with surprise, skepticism, or outright hostility. This is a cultural shift.

In each of these three cases Acme has adopted a new commitment that does not derive from its members’ commitments, or that runs counter to its members’ commitments, and in the latter cases it has done so without the members even being aware that it has happened. Once incorporated into the
structure, the new commitment will nonetheless shape the individual actions of the members in ways that yield reliable corporate actions consistent with that new commitment. I assume all of this is somewhat familiar, or at least easily available via observation, but there are four significant philosophical implications that are not often recognized.

First, these commitments qualify as beliefs and desires on the standard interpretationist, dispositionalist, and representationalist accounts developed to explore human intentionality. Second, these commitments guide action. The many elements of the structure provide multiple, overlapping reinforcements to ensure that the collective actions of the members effectively pursue the things the corporate agent desires (those things towards which the structure reliably guides member action) in accordance with the “picture” of the world captured by corporate beliefs. With that—third—we can recognize that these commitments form a “rational point of view” (RPV)—a logically coherent set of beliefs and desires that guide action. The possession of an effective RPV is the hallmark of an agent. Fourth and finally, this RPV belongs to the corporate agent. While the causal history and supporting mechanisms for these commitments extend (all the way) down into the membership, the content, integration, and effectiveness of the commitments reside at the corporate level. Given that these commitments can include commitments about moral matters, and that they in fact guide corporate action, corporate agents are moral agents, with their own moral responsibilities, both prospective and retrospective.

Unlike the joint commitments and collective ends of collectivist theories, the unifying component—the structure—need not be present “in the heads” of its members, and the members need not have matching reasons for subordinating themselves to it. It is external to them (though internal to the corporate agent) and guides their actions indirectly by making desired behaviors instrumental to the members’ own, disparate, personal ends. Because of the way this account incorporates nonstrategic changes to the corporate RPV (via the second and third mechanisms), the intentionality of the corporate agent is far more independent of member commitments and intentions than on more formalistic accounts (like those from French, Werhane, and List and Pettit). Seen from this perspective, the corporate agent appears a less docile


17. I take this concept from Carole Rovane (1997).

18. I acknowledge that this sketch addresses the agency of these corporate agents but not their normative competence. See Hess (2014a, 2015, 2018a) for more details about that capacity; regarding their possession of other potentially necessary capacities of free will and reactive attitudes (see Björnsson and Hess 2017; Hess 2014b).

19. See Hess (2019) for an extended comparison between this account and those from French, Werhane, and List and Pettit.
beast, more resistant to executive control and at the same time more sensitive to the actions of lower-level members. In both these respects the picture is truer to actual practice and has important implications for how we manage these agents; both also carry significant implications for the knowledge, control, and thus moral responsibility of the members.

Looking at the financial crisis and some of the huge players within it, then, it seems likely that we do have agents who meet all five of the criteria for blame. The major firms themselves—Bear Stearns, Nationstar Mortgage, Sun Trust, American Home Mortgage, Countrywide—are likely to be (1) moral agents who (2) acted in ways that significantly increased the likelihood/severity of the financial crisis; in doing so they (3) presumably violated a moral obligation while having (4) sufficient knowledge and (5) sufficient control over events to do otherwise. 20 For each organizational player in the crisis we would still have to make the empirical case, and I will address Countrywide in more detail in Section 5. Speaking broadly, though, it is highly likely that any organization agile and effective enough to function at this level would have the capacities necessary for moral agency 21 and that they violated a moral obligation in significantly contributing to the financial crisis. It is also highly likely that each organizational actor—not necessarily any individual member, but the firm as a whole—had sufficient information to determine what was at stake and to anticipate likely results, and that it could have acted otherwise. To the extent that these and other firms meet these criteria, they will be to blame. The only remaining question is what this implies about their members.

4. COLLATERAL RESPONSIBILITY

Critics have argued that in holding Acme morally responsible we necessarily hold Acme’s members morally responsible for more or less than we should—for more if in blaming Acme we necessarily blame Acme’s members, and for less if in blaming Acme (as a full moral agent) we necessarily excuse the members. Both criticisms turn on specific assumptions about the relationship between Acme and its members and about how blame is allocated among multiple participants.

The careless critic who worries about assigning too much blame to the members generally assumes a relationship of identity between the members and Acme, such that whatever happens to Acme happens to the members. But of course, this isn’t true. Acme can be fined, sold, and dissolved without the members being fined, sold, or dissolved. Just so, Acme can be blamed

20. Note also that many of the governmental entities involved likely qualify as moral agents under this standard, and are thus similarly subject to moral responsibility if they meet the other criteria.

21. Again, it is a matter of some debate whether the sophisticated capacities necessary for rational agency are sufficient for moral agency, or whether additional capacities are necessary, with Frank Hindriks (2014) arguing the latter point. To the extent that further capacities are necessary, I believe that my account already makes room for them (see Hess 2015 for discussion).
The more careful critic, like John Hasnas (2012), makes a more practical point, drawing on the fact that many things that affect Acme will affect the members, even if the effects are not identical. In that case the concern may be that blaming or punishing Acme will negatively affect the members, even if it doesn’t really blame or punish them. (Both blame and punishment require intent, so the impacts on the members will not be “blame” or “punishment”—merely harm.) This is a more reasonable concern. For example, it is entirely plausible that imposing significant fines or other legal penalties on Acme will force Acme into actions that will leave the members worse off (cutting bonuses, salaries, even positions). Even blame, if backed by a substantial customer boycott (say), could lead to negative effects.

In response, I note first that my concern in this article is exclusively with moral responsibility and blame—not with legal liability or penalties—and that the two are unrelated. Despite Hasnas’s rather odd assertion that the only significance of corporate moral responsibility is that it makes corporations “liable to punishment, specifically criminal punishment” (2012, 188), “moral responsibility” is not an element of any crime, corporate or otherwise. So I restrict my analysis to the moral realm.

Second, this is true for all agents. The concern about negative affects doesn’t rely on the distinctive relationship between Acme and its members but on a simple causal chain. As such, the concern is not specific to corporate agents. The concern is that in penalizing or blaming one agent for something it did, we will harm other agents who (in fact) didn’t do it. But this is always a concern. For every human agent who is convicted and imprisoned, or even publicly blamed and shamed, there will be collateral impacts on those who depend on or care about that person. Such concerns are irrelevant to the question of whether the human agent is to blame for something, and of questionable relevance regarding whether she should be blamed or not. If such things mattered we could rarely—if ever—blame anyone. Just so, the fact that blaming Acme may trigger a causal chain with negative results for its members is (1) irrelevant to the question of whether Acme is to blame, and (2) of questionable relevance regarding whether we should blame Acme.

The critic who worries about absolving the members takes me at my word about the relationship between Acme and its members, noting the stark

22. This is one of the many indications that the relationship between the corporate agent and its members is not one of identity, but better understood in terms of composition or constitution, among other possibilities (Hess 2018b).

23. Hasnas acknowledges these points but addresses them exclusively in the context of legal liability, so his analysis is not entirely relevant to the discussion here. He also makes a number of further claims about the goals of the “Corporate Moral Responsibility [CMR] debate” and the motivations of its participants that I do not necessarily agree with, but I set that aside. Here I simply note that the CMR debate has immense implications for corporate moral obligation that he does not consider. Additionally, as Jennifer Quaid (2018) points out, when we refuse to impose criminal liability on the corporate agent, there is a marked tendency to impose it on the lower ranking members who made the final “move” in the problematic chain.
discontinuity between Acme’s commitments and actions and those of its members. Drawing on this discontinuity the critic concludes that Acme is not only “distinct” from its members but entirely separable from them—that if Acme did something then its members did not do it, and that anything that happens to Acme must not have happened to its members. Jan Narveson gives a forceful statement along these lines. Once we recognize a holist entity, he claims, we can infer no individual responsibility at all, whether equal or otherwise. If no [human] individual did this thing, no [human] individual is responsible for it and so no individual can be punished for it…. [The] hypothesis of irreducibility deprives us of any rational means of distributing blame to individuals. (2002, 185–86)

This is actually correct, as far as it goes. If Acme is the agent who polluted the river then it can’t be the case that one or more of its members also performed exactly that same action; if Countrywide defrauded Fannie Mae in a particular instance then it cannot be the case that one or more of its members also defrauded Fannie Mae in that particular instance. Further, given this distinction, when we blame Acme or Countrywide for φing at t, we are necessarily not blaming their members for φing at t (pace the previous critic), and this is appropriate for precisely the reasons Narveson cites. This seems to raise the specter that all those people whose sustained and/or directed activities that led to the collapse are somehow entirely off the hook, with their firms taking the fall for their behavior.

The error here is twofold. First, the critic overstates the distance between Acme and its members. Acme and its intentionality are distinct from its members, but not therefore wholly unrelated to them. As discussed in Section 3, the members from top to bottom have probably played an essential role in developing and supporting Acme’s intentionality—that is, in developing and supporting the corporate beliefs and desires that make up its RPV. Second, the critic assumes that allocations of moral responsibility in collective contexts must be distributive—that there is some finite “amount” of moral responsibility for polluting the river, and that once we have identified Acme as the moral agent responsible for it, there won’t be any left over to distribute to the individual members. We can avoid this difficulty by moving from this distributive paradigm to a paradigm of collateral responsibility.

The paradigm of collateral responsibility is familiar from a number of contexts, and plays out in our moral judgments whenever one agent is held responsible for the free actions of another. We use it when we blame (or praise) parents for the actions of their children, advisors for the actions of


25. Again, this is a paradigm of moral responsibility, not legal responsibility. Our practices with respect to moral responsibility play a role in shaping our practices with respect to legal responsibility, but decisions about legal responsibility are also heavily (and properly) influenced by public policy concerns that have no place in moral reasoning. For example, it is not unusual for a regulatory framework to assign legal responsibility to an actor simply because she would be an effective gatekeeper or has deep pockets, neither of which would have any role to play in a purely moral analysis.
their advisees, and mentors for the actions of their mentees; it is even implicit in the widespread concerns about the effects of poorly behaved role models like athletes, celebrities, and teachers. In each case, the first agent is held responsible because she exercised an unusual degree of influence over the development of the beliefs and desires—the RPV—that motivated the free actions of the other, always without being able to fully control her.

Here’s one example of collateral responsibility. At $t_1$, Barb believes that it would be wrong to pollute the river. Then Ann and Barb have a debate at the end of which Ann has convinced Barb that she was mistaken and that—in fact—she should pollute the river. As a result of Ann’s actions, Barb develops a new belief that she then acts upon, polluting the river. Barb is a moral agent acting freely from her own RPV, with knowledge and control of her own actions and the likely results, and she is thus directly responsible for her own actions and the damage she caused. But Ann was also a moral agent acting freely from her own RPV, with knowledge and control of her own actions and the likely results. As such, she is also directly responsible for her own actions (in influencing Barb) and collaterally responsible for Barb’s actions in polluting the river. Ann is not directly responsible for Barb’s actions here, as she would be if she were directly controlling them by overriding Barb’s RPV (perhaps through hypnosis, or a chip implanted in her brain), but Ann is responsible for influencing Barb, for providing the impetus that led Barb to develop the beliefs and desires which, in turn, led Barb to pollute the river. She has met the criteria for blame laid out above. We hold Ann directly responsible for influencing Barb and, given the immediate connection between that influence and the harmful actions that followed, we tend to recognize that Ann has a kind of derivative, “collateral” responsibility for the pollution.

Parental responsibility for the actions of children presents a more sophisticated and illuminating example of the same basic pattern. Parents are typically held both morally and legally responsible for the actions of their young children; the pattern shows up in statutory law and case law, of course, and—more importantly for our purposes here—in familiar praising and blaming practices. Ordinary people regularly praise and blame parents for the actions of their children despite knowing that parents do not control their children in any robust sense. As in other cases of collateral responsibility, the children are held responsible for their own actions without wholly absolving the parents. As a second example, imagine that Ann and Barb are mother and 12-year-old daughter, and Barb throws a ball and breaks a neighbor’s window despite Ann’s repeated admonishments to be careful. Again, Barb is a moral agent acting freely from her own RPV, with knowledge and control, and is thus responsible for her own actions and the harm that followed from

26. See the survey of parental responsibility laws in Brank, Kucera, and Hays (2005).
27. See the Restatement (Second) of Torts s. 316 and associated case law.
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them. In this case, unlike the previous example, Ann explicitly warned Barb not to \( \varphi \), and yet our standard practices will still tend to treat Ann as somehow blameworthy—especially if Barb makes a regular practice of \( \varphi \)ing.

In the first example, Barb was directly responsible (for polluting the river) because she acted from her own RPV, her own beliefs and desires. Ann was directly responsible for the ways in which she influenced the changes in Barb’s RPV, and collaterally responsible for the pollution that resulted from that influence. In the second example, Barb was again directly responsible (for breaking the window) because she acted from her own RPV, but here the situation with Ann is more complicated. Here, Ann tried but failed to convince Barb to avoid the harmful action. In many situations this would exculpate Ann; here it does not, because of the broad influence parents are taken to have over the development of their children’s beliefs and desires.

In a familiar cultural narrative, parents have a profound influence over the beliefs and desires their children develop. This is especially true in the earliest years, when children are most directly subject to parental influence and have had little time to develop their own commitments from their own experiences, but the influence continues throughout a lifetime. Whatever the child’s RPV, in all but the most exotic of situations the parents will have played a direct causal role in shaping it.\(^{29}\) The narrative does not suggest that parents can fine-tune the RPV so as to precisely engineer the nature of the agent that emerges. If they could, then the child would be a completely controlled puppet and the analogy would fail. Instead, the pervasiveness of parental influence leads us to assign collateral responsibility across an extraordinarily broad set of resulting actions—even, as here, in situations where the parent has explicitly tried to prevent the particular harmful action. This is taken to be appropriate because, despite Ann’s proximate efforts, Ann played such a significant role in shaping the underlying RPV that led Barb to break the window despite Ann’s immediate protests. Thus Barb is responsible for the broken window while Ann is responsible for Barb, with some collateral responsibility for the window.

In each of these cases, we hold Barb fully responsible for her harmful actions while still recognizing Ann’s responsibility. Ann does not directly control Barb, and Barb’s actions cannot be directly assigned to Ann, but Ann is nonetheless directly responsible for the ways in which she influenced the development of Barb’s RPV and collaterally responsible for the harms that flowed from it. This is especially interesting in the second case, where the

\(^{29}\) I make no comment on whether it is true that parents exercise this kind of influence over their children, or whether other factors—peers, culture—play equally significant roles. My only claim here is that (1) this belief is widespread and (2) this belief licenses certain familiar praising and blaming practices. That’s all I need for the argument to go forward. I should also note that, in drawing this analogy, I do not mean to suggest that Acme’s members have an obligation to “nurture” Acme, or stand in loving relations to it or maintain the relationship through thick and thin. It is interesting to note, however, that people often do adopt these kinds of attitudes toward the corporate agents in which they participate.
very pervasiveness of Ann’s influence over Barb constitute grounds for holding her responsible despite her more proximate efforts.

To this extent, each individual member of Acme stands in precisely the same relation to Acme: no individual member directly controls Acme, and Acme’s actions thus cannot be directly assigned to any of them, but each is nonetheless directly responsible for the ways in which she influenced the development of Acme’s RPV and collaterally responsible for the harms (and benefits) that flowed from it. Moreover, at least some of the members exercise a kind of pervasive influence over Acme’s RPV that finds its closest—or at least, most illuminating—parallel in the case of parents and children.

Members of a corporate agent (as contrasted with nonmembers) are likely to exercise a uniquely powerful influence over the development of the corporate RPV via all of the mechanisms outlined in Section 3.30 Without being able to directly tailor that RPV to their personal preferences, each member nonetheless plays a role in bringing it about that the corporate agent has the beliefs and desires that it does, and it is those beliefs and desires that lead the corporate agent to act as it does. Any member who wants Acme to act differently needs to get Acme to “change its mind” about something—to adopt a new belief or desire or reject an old one—and each member has only a limited ability to do so.31 For example, when we left Acme it was in the process of abandoning its existing commitment to environmental stewardship. Members at every level are likely to have some mechanism by which to resist or hasten this change: executives by establishing environmental policies or not; mid-level employees by attending to environmental concerns (or not) in the course of their other decision making, or by raising the issue with other members in more directly relevant areas; and lower-level employees by ensuring that at least their own actions and those of their immediate peers are environmentally sensitive, and/or by reporting any costs associated with environmentally destructive behaviors or benefits associated with eco-sensitive actions.32 Members who contribute to the development of an RPV that leads to moral violation—here, environmental damage—are responsible for the

30. Note that the “influencing” relationship is a causal one, not a conceptual or constitutive one, and it is thus not limited to members or to certain ranks or titled positions within Acme. It is entirely possible that identifiable nonmembers could play a significant role in shaping Acme’s RPV (e.g., nonmember consultants who recommend new strategies and practices without becoming embedded in Acme’s structure). The analysis would be the same regardless of nonmember status.

31. It is always possible that in any specific instance there will, in fact, be one or more members who did not exercise any influence over the development of the corporate RPV. In such circumstances, those members will have no moral responsibility for the actions of the corporate entity. Such circumstances will be exceedingly rare. Even low-level members like line workers and custodial staff can and do play a role in shaping corporate culture, and corporate culture embodies a set of commitments that can have an extremely powerful influence over corporate action. It is often far more effective than direct orders from the CEO and the rest of the C-suite.

32. See Hess (2018a) for a more detailed discussion of the different mechanisms in a Kantian framework.
creation of an agent that does such things. They are collaterally responsible for the harm that results. The paradigm is thus sensitive to the “situatedness” of the members, recognizing that some members are well-placed to exercise pervasive influence while others are not, without completely excluding (or diminishing) the contributions of lower-level members. In any actual instance of corporate action, we thus determine the moral responsibility of individual members by looking at who *in fact influenced* the development of the corporate commitments that led to it rather than looking at individual member intentional states or whether they participated directly in the action itself.

Thus, the critics are wrong: it is not true that recognizing firms as moral agents requires us to blame all or none of its members for what it does. If anything, it facilitates a clearer understanding of the many ways in which members across the collective can contribute to corporate wrongdoing. It’s not just the members most obviously and immediately involved who are to blame, but all of those who contributed to the development of the corporate RPV—a class likely to extend throughout the collective. The existing paradigm of collateral responsibility allows us to recognize the moral responsibility that the members have for both the development of that RPV and the actions that follow from it, and provides helpful guidance regarding what to look for when we *do* seek to hold members individually morally responsible.

### 5. COUNTRYWIDE: A CASE STUDY

What follows is necessarily sketchy. I do not have sufficiently detailed information about what happened within the limits of Countrywide to make precise claims, and I lack the specializations in finance and strategy that would allow me to speak confidently about what either Countrywide or its members “must have or should have known” with regard to their own choices and the consequences that followed. To the extent we really want to do this properly, such matters would have to be settled by specialists and/or a kind of “jury of peers.” With that caveat, however, I can provide a quick sketch of an application and draw what I take to be plausible conclusions about what the data would show and the specialists conclude.

Again, the standard is as follows: X is blameworthy (or “to blame”) for an event (E) only if (1) X is a moral agent, (2) by acting, X could have significantly affected the likelihood or severity of E, (3) X had an obligation to φ, (4) X knew of the obligation and that X’s action violated/failed to meet it, and (5) X was able to φ. As is typical in findings of blameworthiness, this does not require us to identify a single entity who caused E without any contribution from other agents—an impossibility, in any event—nor does it require us to identify a single “but-for” action or actor, a kind of “straw that broke the camel’s back” such that the single event or actor was uniquely significant in bringing E about. It simply requires agency, action, knowledge, control, and a significant contribution. And collateral responsibility is the same.
Countrywide itself is probably responsible—blameworthy—for the financial crisis. It would surely qualify as a corporate agent on the account outlined above, and it was thus capable of acting on the basis of morally relevant information (whatever the reader takes that to involve—harm, respect, or virtue). To the extent that it did not, it acted immorally, not amorally. As a moral agent Countrywide had traditional moral obligations. Whether the reader takes those to be grounded in utilitarianism, Kantian ethics, or virtue ethics, it seems highly likely that “contributing to triggering the financial crisis in pursuit of its own ends” would violate those moral obligations. And it seems highly likely that Countrywide’s choice to pursue its ends by offering ever riskier, ever more exotic, ever more dangerous loan products to its customers—in its own right, and in its extended effects of normalizing such behavior by other underwriters—significantly contributed to the financial crisis.

The remaining elements are harder to establish, and it is important to emphasize that—at this point—the question is whether Countrywide itself knew or should have known that its actions were immoral and/or likely to bring about something like the financial crisis. The question is not whether its members knew or should have known, but if Countrywide itself did. Countrywide (and Acme, and other corporate agents) are not “sum totals” of their members. Beyond its physical aspect, there is a stark discontinuity between the members and Countrywide: it does not believe everything they believe, desire everything they desire, or know everything they know. So did Countrywide know—or should it have known—that, say, its actions were extremely risky and had the potential to trigger a massive collapse, given predictable actions by others? Assuming that knowledge requires justified true belief: probably. Going by Adam Michaelson’s account of internal discussions at Countrywide, it seems that significant numbers of high-ranking members had reviewed data which suggested the possibility (which Michaelson himself raised in a large meeting, and brought to the attention of others) and had debated it at some length (Michaelson 2009, 1–25, 199–207). It was not a worry hidden silently in someone’s mind, but a matter of open discussion that shaped member behavior in pursuit of corporate goals. Though the details will vary depending on whether one takes an interpretationist, dispositionalist, or representationalist approach to the matter of belief, this will generally be sufficient to qualify on any of them (again, see detailed discussion of each at Hess 2014a). To the extent that the belief was both justified and true—which it seems to have been—Countrywide knew that its actions were extremely risky and had the potential to trigger a massive collapse. The remaining question of whether Countrywide could have acted differently, drawing the line at some point and refusing to offer yet riskier options, is interesting and takes us deep into the free will literature. Setting aside the complexities, I will simply note that it was metaphysically and nomologically possible for Countrywide to do so. It would have required discipline and foresight, to go against the crowd and

33. See Hess (2014a; 2018b) for more detailed discussion of both relationships.
abandon the easy profits available through predatory lending, but it was possible, however unlikely.\footnote{In this, it is worth noting that Countrywide was a member of an “unstructured collective” of firms and government agencies—blameworthy moral agents all—who together did effectively cause the financial crisis, and together could have effectively prevented it in its entirety, or radically reduced its severity through coordinated action far beyond what any single firm or agency could achieve in its own right. See Igneski (2018) regarding moral responsibility in such situations.}

That brings us to the responsibility of Countrywide’s members. Drawing again on Michaelson’s account (which seems generally consistent with other sources), it seems that Countrywide’s RPV was generally dominated by a twofold imperative, both to “help people achieve the American Dream” by purchasing their own homes, and to maximize profit. From Michaelson’s description, the former was not simply marketing; people within Countrywide seem to have been sincerely motivated by this corporate end, under this description, and by ensuring that Countrywide acted to bring it about across an unfortunately wide array of circumstances, they ensured that Countrywide itself was sincerely motivated by this end. To some extent these imperatives were pursued by separate aspects of the company, but both played a significant role in generating the behaviors that brought Countrywide down. In terms of member responsibility, then, on my account, the question is: Who contributed to those commitments? Where did they originate, and who contributed not just to their continuing efficacious existence but to their evolution into the telepathic forms they had assumed by the end?\footnote{Note again that this may well involve external consultants as well as members. The membership relationship makes it likely that an agent will be unusually well placed to influence a corporate agent’s RPV, but it is neither necessary nor sufficient.} This is where I lack sufficient data to provide actual names, but whoever they are … they are the agents who are potentially blameworthy—directly responsible for the commitments Countrywide developed as a result of their influence, and collaterally responsible for the results of its action on the basis of those commitments.\footnote{It is noteworthy that Countrywide was such a young company—only 38 years old in 2007 when the slide began—and still apparently dominated by its founder’s personality and decision making. To the extent this was the case and not just marketing, this would suggest that Angelo Mozilo bore a much greater share of the responsibility than would be true at longer-established firms.}

For each agent we would need to show that all five elements are present. All will presumably be moral agents with moral obligations, and all will have contributed to Countrywide’s development of the particular commitments that led to its malfeasance (because that’s how we’ve defined the class). Beyond that, it is plausible that “convincing” Countrywide to become what it became violated those moral obligations in the same way and for the same reason that Ann convincing Barb to pollute the river, or teaching Barb to be careless of others, plausibly violates moral obligations. The only remaining requirements will be to show that the contributing agents—like Countrywide itself—knew
or should have known that they were contributing to the creation of an agent likely to behave in such ways, and that they could have done otherwise. It seems likely that both will be true in at least some cases, most especially higher up in the company, but also likely that responsibility will extend deeply into the ranks of the members engaged directly with customers.

Finally, I’d like to note that none of this makes the members of Countrywide—or of any of the other corporate agents involved—“bad people.” It suggests that many or most of them should experience reactive attitudes like shame, guilt, and remorse for the role they played in bringing Countrywide to act the way it did, and that they should be disposed to express those sentiments and to be somewhat prepared to make amends. (In fact, it suggests that same of Countrywide; see Björnsson and Hess (2017) regarding corporate reactive attitudes.) From my research, none were rapacious monsters or movie villains set on market domination at any cost. They were all just people, caught up in the collective structures and constraints of a corporate agent reacting to familiar imperatives built into its structure and the larger competitive structure of the marketplace.

That is the piece that makes the whole tale so sobering.37

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37. My thanks to participants in the seminar series in the Legal Studies and Business Department at the Wharton Business School for helpful comments on an earlier draft of this article.
Who’s Responsible? (It’s Complicated.)


1. INTRODUCTION

The financial crisis of 2007–2009 caused serious harm. In the United States alone, millions of people lost their jobs and homes, and trillions of dollars of wealth were erased. According to an existing narrative, the crisis was due in part to executive compensation packages in the financial services industry that incentivized excessive risk-taking (Kolb 2012). Also according to this narrative, those who have a duty to protect society—principally, government regulators, but perhaps also firms themselves—are open to blame for how executives were paid, and must take steps change executive compensation.

The above narrative can be described as “environmental” because it focuses on a feature of executives’ environment, viz., their incentives. I argue that this narrative is important but incomplete. It is important because there is good reason to believe that it is true, and it identifies a way to reduce the likelihood of future crises. It is incomplete because it minimizes executives’ own agency in the crisis. I offer a new “agential” narrative. According to this narrative, executives are not at the mercy of their compensation packages; their pay does not determine how they act. This means that executives are open to blame for the financial crisis for taking socially excessive risks. Moreover, since executives can play a role in shaping their compensation, they have an obligation to ensure that it does not incentivize them to take such risks. Taking the agential narrative seriously requires seeing executives not merely as actors in the financial system, but as stewards of it.

A terminological note. I am concerned in this article with the pay of, as I describe them, “executives in the financial industry.” I am not concerned,
however, with the pay of the employees of local banks who make a small number of home loans each year. My concern is with the pay of individuals in financial institutions who have the power to expose their firms, by taking positions on financial assets, to millions or even billions of dollars of downside risk. For convenience, I call these individuals “executives.” “Executive” typically refers to an individual at the highest levels of an organizational hierarchy, such as the CEO, CFO, or COO. Following standard practice (Bebchuk, Cohen, and Spaman 2010; Bebchuk and Spaman 2010), my use of “executive” is broader than this, and includes senior securities traders in addition to high-ranking corporate officers.

2. EXECUTIVE COMPENSATION AS A CAUSE OF THE FINANCIAL CRISIS

The financial crisis can be understood as the result of a series of large bets that went bad. Banks loaned money to people to buy houses, betting that borrowers would be able to pay this money back. Banks sold these loans to other financial institutions, who in turn bet that these were prudent investments. Financial institutions sought to hedge their investments in the housing market by taking out a type of insurance contract on them, a credit default swap. The sellers of these contracts bet that the underlying investments would not go bad in large quantities. And so on. Of course, many of these bets did go bad. In some cases the bets were so large, and went so bad, that the bettor did not survive. And because financial institutions are linked to each other through a complex web of investments and contracts, in some cases a failure in one institution led to failures in others. At the height of the crisis, several major financial institutions had either declared bankruptcy (e.g., Bear Stearns, Lehman Brothers) or were on the verge of bankruptcy (e.g., Morgan Stanley, RBS, AIG). In response, governments infused large amounts of money into them in the form of low-interest loans and guaranteed even larger amounts of their debt. It is hard to know exactly how much this cost the public. According to The New York Times, however, as of April 30, 2011, the U.S. government alone had spent $2.5 trillion on the bailout, and had made financial commitments in excess of $12 trillion (Adding Up the Government’s Total Bailout Tab, 2011).

What caused financial executive to make such bad bets? Many factors have been cited: lax regulation, excess liquidity, opaque financial instruments, unreliable ratings agencies, and garden variety greed. It is impossible to say which of these factors was the most important. But many observers now agree that the structure of executive compensation packages in the financial services industry contributed in a significant way to the financial crisis (Kolb 2012).¹

Ben Bernanke, Chairman of the U.S. Federal Reserve during the crisis, said that “[c]ompensation practices at some banking organizations ... led to

¹. The following summary draws on Larcker et al. (2014). See also Kolb (2012). For a contrary view, see Fahlenbrach and Stulz (2011).
misaligned incentives and excess risk-taking, contributing to bank losses and financial instability” (Board of Governors 2009). Timothy Geithner, U.S. Treasury Secretary, said that while “many things caused this crisis, what happened to compensation and incentives in creative risk-taking did contribute in some institutions to the vulnerability that we saw” (Highlights 2009). And Alan Blinder, former Vice Chairman of the U.S. Federal Reserve, said that one of the “fundamental causes” of the financial crisis was the “perverse incentives built into the compensation plans of many financial firms, incentives that encourage excessive risk-taking” (Blinder 2009). Government officials are not the only ones to hold these views. In a KPMG survey of 500 senior risk management professionals in the financial industry, 52 percent identified “incentives and remuneration” as the factor “most at fault in contributing to the credit crisis.” According to a 2008 survey of financial professionals by PricewaterhouseCoopers, the three factors most commonly cited as causes of the financial crisis were a culture of excessive risk-taking (73 percent), mis-pricing of risk (73 percent), and rewards systems (70 percent) (cited in Larcker et al. 2014).

To be clear, the problem is not that financial executives’ compensation packages incentivized them to take risks that were bad for their own firms, though this may have been true in some cases. The problem is that they incentivized executives to take risks that were bad for society. An executive’s risk-taking can be socially excessive without being excessive for her own firm. Indeed, some risk-taking that is optimal for an individual firm may be socially excessive (Bebchuk and Spamann 2010, 274–75). The reason is, as noted, that a loss for a large financial institution can have significant negative externalities. Large financial institutions are powerful, interconnected, and provide essential services to society. When one suffers a loss, it can cause other financial institutions to suffer losses, and these losses can be felt by society as a whole (Kolb 2012; Scharding 2015).

According to regulators, observers, and participants in the financial industry, then, there is a problem with compensation for financial executives. That is, the way that they are paid creates an unacceptably high risk of social harm. We can call this “the problem of risky pay.” Having described the problem, now let us consider what should be done about it, and who should do it.

3. RESPONSIBILITY FOR RISKY PAY: WHAT AND WHO?

Lucian Bebchuk is a leading voice on risky pay in the financial industry (see also Kolb 2012). Together with various collaborators, he has advanced several proposals for making pay less risky (Bebchuk, Cohen, and Spamann 2010; Bebchuk and Fried 2010; Bebchuk and Spamann 2010).

One problem Bebchuk sees is that many executives undercut the incentive effect of the stock that they receive as compensation by selling that stock as soon as they can. For example, the top executives of Bear Stearns and
Lehman Brothers—two financial institutions that failed during the crisis—received nearly $2 billion in proceeds from stock sales during the period 2000–2008. In particular, “Lehman’s CEO took home about $461 million and Bear Stearns’ CEO took home $289 million” (Bebchuk, Cohen, and Spamann 2010, 268). In response, Bebchuk advocates restrictions on stock sales: executives should be required to hold grants of stock for a period of several years, and should not be able to sell more than a certain percentage of their holdings in a given year (Bebchuk and Fried 2010).

Another way that executives can undercut the incentive value of their compensation packages is by hedging their positions in their firm’s stock. For example, upon receiving a grant of restricted stock, an executive might hedge those shares, securing immediate payment and eliminating downside risk. Bebchuk advocates restricting this practice. He says that firms should develop explicit anti-hedging policies and require executives to sign affidavits affirming that they have observed them (Bebchuk and Fried 2010, 1956).

Finally, Bebchuk sees evidence that stock purchases and sales by executives are timed to coincide with the release of corporate information that moves the price of the stock. Grants of stock are given just before good news is announced, so that executives can benefit from the subsequent price increases. Executives sell just before bad news is announced, so that they can avoid the resulting price decreases (Bebchuk and Fried 2010). This enables executives to capture the gains from stock movements while avoiding the losses. To avoid these problems, Bebchuk says, both the awarding and the selling of stock should be done on a schedule that is publicly announced by the firm in advance, and that is out of the executive’s direct control.

More could be said about these recommendations, and other recommendations could be devised (see, e.g., French et al. 2010 and Kolb 2012). But this will suffice for our purposes. I am less interested in the question of what should be done to make pay less risky than who should do it. That is, who are these recommendations for?

In one place, Bebchuk offers his recommendations to “firms, compensation experts, investors, policymakers, and regulators in their ongoing efforts to improve executive compensation” (Bebchuk and Fried 2010, 1957). All of these parties have the power to do something about the structure of executive compensation. Compensation experts can offer firms different advice, firms can make executives different compensation offers, and regulators can write new rules regarding compensation. Bebchuk does not think, however, that all these groups will be equally motivated to make executive pay less risky, and in particular, less socially risky. He says that parties whose interests are not adversely affected by executives’ risk-taking “cannot be expected” to curb it (Bebchuk and Spamann 2010, 278). Firms and the compensation experts they hire may be motivated to make executive pay less risky from the firm’s point of view, but not from society’s point of view. The job of ensuring that the structure of executives’ compensation does not incentivize them to take socially excessive risks falls to society itself. Of course, this function will not be performed by
ordinary citizens, but by society’s experts in finance and corporate governance, including its legislators and regulators.

What, if anything, can we learn from these reflections about blame for the financial crisis—or more precisely, blame for the crisis to the extent that it was caused by the structure of executive compensation? This subject does not get much attention. Writers are more focused on what can be done to fix risky pay than on who deserves blame for it. But insofar as we are searching for parties to blame, the first question we might ask is: who has a responsibility to protect society from socially excessive risk-taking by executives in the financial industry? One natural answer is: government regulators. Government regulators have a duty to protect society from harm, including environmental harm, social harm, and economic harm. Insofar as regulators failed to protect society from excessive risk-taking by financial executives, we might say, they failed in this duty. But we might also think that firms themselves are open to blame for incentivizing their executives to engage in socially excessive risk-taking. Whatever the current regulations say, we might think, firms should not subject society to a grave risk of serious economic harm. With Bebchuk, we might not trust firms to make executive compensation less socially risky; still, we might think that they have a duty to do so.

To say that governmental regulators, and perhaps firms themselves, are open to blame for the financial crisis is not yet to say that it is appropriate to blame them. Minimally, blame requires knowledge and ability (Tognazzini and Coates 2016). Suppose that I have a duty to take care of your plant while you are away on vacation. I fail to water the plant, and it dies. It is appropriate to blame me for the plant’s death only if I knew, or should have known, that the plant needs to be watered to live, and I had the ability to water the plant. I should not be blamed for the plant’s death if I did not know, and could not reasonably have known, that the plant requires water. Nor can I be blamed if I knew that the plant needs water but I was not able to water it, for example, because there was no water available. In the case at hand, it is reasonable to suppose that both regulators and firms had at least some ability to alter executive compensation so that it incentivized less risk-taking. Regulators could have placed limits on executive compensation, and firms could have made their executives different compensation offers. But it is not clear that regulators or firms knew, or should have known, that the structure of executive compensation would contribute to the financial crisis (cf. Bebchuk and Spamann 2010).

I will not try to say whether, ultimately, regulators and firms should be blamed for the financial crisis, insofar as it was caused by the structure of executive compensation. I conclude only that these parties are open to blame, and whether blame is appropriate depends on questions yet to be answered about knowledge and ability.

To this point, I have summarized an existing “environmental” narrative about responsibility for the financial crisis. According to it, a cause of the crisis was executive compensation in the financial industry which incentivized
excessive risk-taking. Also according to this narrative, the structure of executive compensation must be changed. Regulators have the primary responsibility for carrying out this project, and firms may also play some role in it.

4. ENVIRONMENTAL AND AGENTIAL NARRATIVES

I will now argue that this narrative, while important, is incomplete. This is because it minimizes the executive’s agency. In both the framing of the problem and the solutions to it, the executive is not treated as a responsible agent. Based on this criticism, I articulate a new narrative, one that emphasizes executive agency.

Overlooking the agency of the executive begins in the diagnosis of the problem, as found in statements by Bernanke and others. In their diagnoses, pay is conceived of as a kind of cause. The way financial executives were paid, it is claimed, caused them to engage in socially excessive risk-taking. But of course pay alone did not cause executives to engage in excessive risk-taking. Rather, executives themselves decided to engage in that behavior. It is true that executives were incentivized to place large and risky bets by the promise of large rewards for success, and small penalties for failure. However, being incentivized to place a bet is not the same as being forced to place a bet. The executive is not at the mercy of her compensation package. She is capable of making safe choices, even when she is incentivized to make risky ones.

Overlooking the agency of the executive continues in the solutions that have been offered to the problem. The proposals offered by Bebchuk and others are protective in nature. They are designed to guard against the harm that may be caused by executives’ risk-taking. This perspective is too narrow. The risks posed to society by financial executives are not like the risks posed by earthquakes and mountain lions. Executives are not forces of nature or wild animals. They are responsible agents with the ability to modify their behavior in response to moral reasons. They can resist the incentives they have. They can also in some cases change their incentives.

An analogy will help to illustrate my point. Suppose person P enjoys gambling on horses, and in particular, placing large bets on horses that have a small chance of winning. Suppose that P eventually loses a lot of money on a horse, and his losses are so significant that he cannot care for his children adequately. P’s children suffer as a result. Now consider who is to blame for the suffering of P’s children, and what can be done to prevent them from suffering in the future. One narrative that might emerge—an environmental narrative—is that P’s society is to blame for the suffering of P’s children, and that P’s society should take steps to ensure that P’s children do not suffer in the future. Perhaps the government should adopt new rules that limit how much a person can bet on a horse, or perhaps it should outlaw gambling altogether. Alternatively, perhaps gambling institutions should decline to accept large bets from people they know to be poor. Another narrative that might
emerge—an agential narrative—is that *P himself* is to blame for his children’s suffering, and *P himself* should take steps to ensure that they do not suffer in the future. Minimally, we might say, P should resolve not to gamble in such a way that his children will suffer if he loses. Beyond this, perhaps P should steer clear of the track, cut up his credit cards, or attend Gamblers Anonymous meetings.

When thinking about questions of responsibility for the suffering of P’s children, I suggest, both of these narratives are legitimate, and should have some purchase on us. P did cause his children to suffer by gambling. In typical circumstances, he can be blamed for his behavior, and he should take steps to eschew that behavior in the future. At the same time, if P’s society—both those who regulate gambling institutions and gambling institutions themselves—had taken steps to make gambling harder to engage in, then P’s children might not have suffered. In sum, neither the environmental narrative nor the agential narrative should dominate the discourse about responsibility for P’s children.

But something analogous to this is precisely what is happening in the current discourse about the role of executive compensation in the financial crisis. The current discourse consists almost exclusively in an environmental narrative about the structure of executive compensation in the financial industry, and what can be done by regulators and firms to change it. It does not feature an agential narrative about executives’ choices to engage in socially excessive risk-taking, and how they might have made different choices. This is a mistake—just as it would be a mistake to focus entirely on the environmental narrative to the exclusion of the agential narrative in the case of P. To be sure, we must be willing to take seriously the environmental narrative that emphasizes the structure of executive compensation in the financial industry. There is good reason to believe this narrative is true, and thus identifies a means of preventing future financial crises. But we should take just as seriously, if not more seriously, the agential narrative that emphasizes executives’ own choices to engage in excessive risk-taking and how executives can bring themselves to make different choices.

The defectiveness of the discourse about executive compensation and executives’ actions can be seen in another way. When firms do well, executives are often praised. They are put on the cover of magazines; books are written about them; they appear on television to discuss the issues of the day. In these venues, it is rare to downplay the executive’s own responsibility for his firm’s success, and credit instead the structure of his compensation package. (The designer of the executive’s compensation package does not go on television.) But this is effectively what is happening in the discussion of the causes of the financial crisis. Executives’ incentives are blamed while their actions are downplayed. Rationality requires consistency in our judgments across these cases.

It is worth noting that the imbalance between the environmental and agential narratives that we find in the case of financial executives is not
replicated in the case of homeowners. In the midst of the mortgage crisis, CNBC’s Rick Santelli famously described being delinquent on one’s mortgage as a kind of “bad behavior” and asked whether society should “subsidize the losers’ mortgages.” Instead of rewarding these people who “drink the water,” Santelli said, we should reward those who “carry the water.” While Santelli did express concern about the role of government in the economy, he did not attribute homeowners’ delinquency to their incentives, or ask how regulators or banks should change those incentives. Instead, Santelli saw homeowners as proper targets of blame for their “bad behavior,” choosing to drink the water that others chose to carry. My suggestion is not that the discourse regarding executives’ incentives and their actions should be exactly like the discourse regarding homeowners’ incentives and their actions, as represented in Santelli’s remarks. This discourse is probably imbalanced in the other direction: too much agency, not enough environment. My suggestion is only that, in the case of executives, the agential narrative needs greater emphasis.

5. TAKING THE AGENTIAL NARRATIVE SERIOUSLY

What would it mean to take the agential narrative for executives seriously? Taking it seriously, I suggest, alters our views about responsibility for the crisis, both in the sense of who is to blame for it, and who has a duty to prevent future crises.

Consider first blame. In the case of P, we concluded that P could be blamed for exposing his children to a serious risk of suffering by placing big bets on horses with low odds of winning. In the case at hand, I noted that regulators and firms are open to blame for the crisis, since they failed to implement policies that might have curbed socially excessive risk-taking by financial executives. When we begin to see executives as responsible agents, we may also regard them as open to blame for the crisis. While regulators and firms allowed the existence of executive compensation packages that incentivized excessive risk-taking, executives themselves took excessive risks. We cannot conclude decisively at this point that financial executives should be blamed for the financial crisis. As in the case of regulators and firms, it depends on whether executives knew, or should have known, that this behavior would contribute to the crisis, and whether they could have abstained from it. My point is simply that, like regulators and firms, executives are open to blame.

The more important question is, what does this mean for the responsibilities of executives going forward? Put another way, what does taking executives seriously as agents mean for what they should do? In the case of P, we concluded that P should, minimally, resolve not to gamble in such a way as to expose his children to unnecessary harm. The reason is simple. Exposing one’s children unnecessarily to serious harm is wrong. A similar conclusion can be drawn in the case of financial executives. They should

2. The video of Santelli’s speech is accessible here: https://www.youtube.com/watch?v=bEZB4taSEoA
resolve not to engage in the kind of risk-taking that contributed to the financial crisis. And they should not engage in this behavior even if they are incentivized to do so by their compensation. The reason is likewise simple. The financial crisis was a source of serious harm to society, and it is wrong to contribute unnecessarily to serious harm.3

My first conclusion assumes that executives can resist their incentives. However, it does not assume that executives are impervious to their incentives. This is clearly false. This leads me to my second recommendation. That is, executives should take steps to ensure that their compensation packages do not incentivize socially excessive risk-taking. In the case of P, we concluded that P should make changes to his environment to make it less likely that he will gamble in such a way as to cause his children to suffer. P should cut up his credit cards or attend Gamblers Anonymous meetings. An analogous conclusion can be drawn in the case of financial executives. They should make changes to their environment to make it less likely that they will take risks that cause society to suffer. Recall that Bebchuk (Bebchuk and Fried 2010, 1957) offers his proposals for improving executive compensation to “firms, compensation experts, investors, policymakers, and regulators.” What I am suggesting, in effect, is that executives also belong on this list.4 Executives’ efforts to improve their own compensation must be an ongoing process, because executives’ incentives are not just a function of the compensation packages they receive initially from their firms. They are also a function of executives’ actions once they receive those packages. Executives need to work proactively with boards to ensure that the pay packages they are offered do not contain rewards for risk-taking that are too large, and do not expose them to too little downside risk. Once a pay package is accepted, the executive needs to ensure that she does not dramatically alter the incentives it provides. For example, the executive should not hedge the stock she receives, because this has the effect of eliminating downside risk, making it more attractive to her to engage in socially excessive risk-taking.

To sum up the article so far: I have identified an existing narrative, highlighted some of its shortcomings, and suggested a new narrative. The existing narrative is environmental. It identifies an environmental cause of the

3. In an important paper, Scharding (2015) evaluates the ethics of risk-taking in the financial industry through a Kantian lens, concluding that Kantian ethics “prohibits [investments] that risk … the integrity of the economic system” (262). My claim here is compatible with but stronger than Scharding’s. I argue that investments are unethical if they pose a grave risk of serious economic harm, but a harm can be serious even if it does not lead to the destruction of the financial system.

4. Many commentators believe that, if there is something wrong with executive compensation, the blame does not lie with executives, provided that they do not try to use their influence over their boards to extract above-market rents from their firms (Bebchuk and Fried 2004). If executives get paid too much, the thinking goes, the fault lies with boards of directors, who are spending the firm’s resources unwisely. In Moriarty (2009), I challenged this view, arguing executives should take a more proactive role in the determination of their pay. In particular, I claimed, executives must think about the effects of their pay on their firm’s welfare. The view I am arguing for here can be seen as an extension of that idea. Here, though, my claim is that executives must think about the effects of their compensation on society’s welfare.
financial crisis—viz., the problem of risky pay—and implies an environmental solution—making pay less risky. This narrative is important but incomplete. I have supplemented it with a narrative that takes executives seriously as moral agents. This agential narrative identifies an agential cause of the financial crisis—what we might call the problem of risk-loving executives—and suggests an agential solution—executives should resolve not to engage in socially excessive risk-taking, and should take steps to ensure that their pay does not incentivize them to do so. When we take the agential narrative seriously, we will see executives as open to blame for the financial crisis, and as having a duty to take steps to prevent future crises.

6. OBJECTIONS AND REPLIES

In the remainder of this article I consider challenges to the agential narrative and the conclusions I draw from it about blame and responsibility.

6.1 Are Financial Executives Like Gamblers?

My argument in this article relies on an analogy between an executive taking a position on an asset in a financial market and gambler placing a bet on a horse at a racetrack, both of which turn out to be unprofitable. In both cases, I argued, the problematic result should be explained by appealing to both an environmental narrative (i.e., about incentives) and an agential narrative (i.e., about choices). The first objection denies that these cases are analogous.

The executive, it might be said, is engaged in a socially important activity. In trading mortgages (and other financial products), he is helping to ensure that society’s limited supply of capital flows to its most productive uses. His trades help to price accurately financial assets and to provide liquidity to financial markets. But the person betting on horses at the racetrack, it might be argued, is not engaged in a socially important activity. He is simply trying to guess how fast horses will run. Perhaps this gives the bettor a small thrill, but it provides no value to society.

This objection is misguided. First, it sells betting on horses short. Betting on horses does provide value to society. Many people enjoy betting, including the possibility of winning. But what makes winning possible is that many people make bets. Without betting, there would be no winning. Moreover, not all of the money that individuals place as bets is distributed to the winners. Some of it goes to the people who make horse racing possible, including jockeys, trainers, and racetrack owners. Betting on horses is thus a source of income for many people.

This is not to say, of course, that all bets on horses are on balance a good thing, or that all kinds of betting should be permitted. In the case above, the individual who is poor and has a family to feed arguably should not be permitted to place a large bet on a horse with a small chance of winning. But the same is true of the “bets”—or trades—made by financial
executives. Trading in financial markets is in general a good thing, for the reasons identified above. But it does not follow that all trades should be permitted. Some trades expose society to too much risk. These are the bets that we are concerned with, and that executives should avoid making.

It might be replied at this point that the “bets” on securities made by financial executives provide more social value, on average, than the “bets” on horses made by people. That may be so. But my argument does not assume otherwise. The question is simply whether it makes sense to invoke both environmental and agential narratives when trying to explain problematic results that come from these forms of betting. I have argued that it does.

6.2 Was the Financial Crisis a Bad Thing?

Both the environmental and agential narratives are narratives about blame and responsibility for the financial crisis. Both thus assume that the financial crisis was a bad thing, that is, an event that was bad in itself, or something to be avoided in the future. We do not blame people for bringing about good or neutral outcomes, or take steps to prevent such outcomes from reoccurring. The second objection denies that the financial crisis was a bad thing.

Economists have long claimed that an important driver of economic progress is “creative destruction” (Aghion and Howitt 1992). In a competitive economy, individuals lose their jobs, companies fail, and industries die out. But out of this destruction come new jobs, new companies, and new industries. While the destruction is painful, the benefits it produces typically outweigh the costs. This is not to say that the benefits outweigh the costs for all individuals, even in the long term. Many farriers lost their jobs when the automobile replaced the horse as the dominant mode of transportation, and some probably did not find better jobs. But society as a whole benefitted from this replacement. Travel by car is more efficient and cheaper than travel by horse.

Viewed as an instance of “creative destruction,” it might be claimed that the financial crisis was not a bad thing overall. While millions of people lost their jobs and homes and trillions of dollars of wealth were destroyed, new ideas about banking, risk, and markets have emerged. If this is right, then executives—and everyone else, including regulators—have nothing to be blamed for, and need take no steps to avoid a future crisis.

Two points can be made against this objection. One is that, even if creative destruction is in general good for society, it does not mean that each and every instance of it is good for society. We might be happy as a general matter that new industries rise up to replace old industries, but think it is bad for a certain industry to die out. Indeed, we might decide as a society not to let certain industries die out. During the financial crisis, the U.S. refused to let its auto industry die out; this industry, along with many banks, was the recipient of a government bailout.

And in fact—and here is my second point—most commentators appear to have decided that the financial crisis of 2007–2009 was not a valuable
instance of creative destruction. Thousands of pages have been written on its
causes and on how to prevent future crises. This would make little sense if
the crisis were an instance of necessary suffering on the way to a better state
of affairs. Of course there may be some who think that these commentators
are wrong; that the disaster should have been allowed to run its course; and
that a better state of affairs would have emerged. But this is a minority
position. In any case, I will assume, with most others, that the financial crisis
was a bad thing, and that it makes sense to think about who bears respons-
sibility for it.

6.3 Small Contributions to Big Harms?

The next objection grants that the financial crisis was a bad thing, but claims
that individual financial executives should not be blamed for causing it, and
have no responsibility to try to prevent future crises. The reason, according
to this objection, is that refraining from socially excessive risk-taking imposes
a significant cost on the executive while producing a negligible benefit for
society. People are not, it might be claimed, required to bear significant costs
to themselves for the sake of producing negligible benefits for others (see,
e.g., Sinnott-Armstrong 2005).

An analogy might be drawn with pollution. When I drive my car, I
release a small amount of pollution into the air. That pollution contributes
to global climate change, a phenomenon which causes serious harm to society.
However, it seems unreasonable to claim on this basis that I have a duty
not to drive my car. Refraining from driving would be very costly for me,
since it would require a major adjustment in my lifestyle. And it would
produce a negligible benefit for society, since global climate change is a result
of billions of tons of carbon being pumped into the air, and the contribution
I make through driving is vanishingly small. We might say something similar
about financial executives. Refraining from placing risky bets would be costly
for them, since it requires them to forgo opportunities to earn very large
financial rewards. But it would produce negligible benefits for society, since
the risk to society of any single executive’s risk-taking is vanishingly small.

Neither element of this analogy is apt. First, it is wrong to suppose that
a single executive’s risk-taking makes a vanishingly small contribution to a very
large problem (viz., to financial instability), as driving my car does (viz., to climate
change). Unlike the case of the climate, where there are billions of contributors
to the problem, there are at most several thousand people in the financial services
industry who command sufficient resources to engage in risk-taking that poses a
grave risk to society. The impact of these well-placed financial executives on the
financial system is much more significant than my impact on the climate.

Second, it is wrong to suppose that refraining from excessive risk-taking
necessarily imposes a significant cost on executives. This assumes that execu-
tives will have access to the largest rewards only if they take the largest risks.
But regulators, together with executives, should be working toward a state
of affairs in which this is not the case. There is no reason to suppose that, in this new reality, executives will be paid less than they are now paid. Restructuring executives’ compensation so that it does not incentivize excessive risk-taking does not require lowering it, only changing the mix of fixed and variable pay. Even if the current structure of executive compensation cannot be changed, it is still implausible to suppose that refraining from placing risky bets would require executives to bear significant costs, of the sort I would bear if I were to stop driving my car. While abstaining from excessive risk-taking may have a high monetary cost, the cost in terms of welfare is likely to be small. This is due to the declining marginal utility of money. The executives who have the power to expose society to grave risks through their actions are typically already very wealthy.

6.4 Legal Freedom as Moral Freedom?

It might next be objected that executives should be free, within the rules established by legal and regulatory authorities, to do as they please. If taking socially excessive risks is legally permissible, it might be said, then it is morally permissible. It follows that executives cannot be blamed for their actions, even if those actions contributed to the financial crisis, and that executives need not alter their actions in the future so as to avoid new crises.

This objection is a familiar one in business ethics, and it fails, for a familiar reason. In general, just because an action is legally permissible does not make it morally permissible. It is wrong for me to lie to or cheat on my spouse, even though I would break no laws in doing so. In the case at hand: it is morally wrong for a person to expose others to a grave risk of harm, whether or not he is permitted to by law. Therefore, it is morally wrong for executives to take positions on financial assets that expose society to a grave risk of economic harm.

Consider an analogy. Suppose that good evidence emerges that driving while talking on the phone poses risks that are just as significant as the risks posed by driving while texting. But suppose that the jurisdiction in which a person P lives has not made driving while talking on the phone illegal. Perhaps the telephone industry has lobbied aggressively against this legislation, or perhaps the legislature simply has not had time to act. Would it be permissible for P under these circumstances to drive while talking on the phone? The answer is no. P would be subject to blame if, knowing this, he talks on the phone while driving. Moreover, P should take steps to ensure that he does not do so, for example, by putting his phone out of reach when he gets into the car.

The lesson in the above case applies to executives and socially excessive risk-taking. At present, it is legally permissible for executives to place certain very large and risky bets. But there is good evidence that their doing so poses a grave risk of harm to society. Just as it would be wrong in our imagined scenario for P to talk on the phone while driving, even if
it is legally permissible for him to do so, so it is wrong for executives to place excessively risky bets, even if it is legally permissible for them to do so. And just as P should take steps to avoid talking on the phone while driving, so executives should take steps to avoid placing very large and risky bets.

6.5 Competing Moral Obligations?

The previous objection claims a *freedom* for executives to engage in socially excessive risk-taking. Next it might be claimed that executives have a *duty* to do so. We noted above that some risk-taking that is socially excessive can be optimal for an individual firm (Bebchuk and Spamann 2010). Many writers believe that executives have a duty to do what is best for their firms (where what is “best” may, but need not, be understood as what maximizes shareholder value) (Bainbridge 2008; Jensen 2002). If so, then it may seem to follow that executives have a duty to engage in socially excessive risk-taking. According to this line of thought, then, the situation that we are in is not a conflict between freedom and the duty not to risk serious harm to society, but a conflict between duties, viz., the duty to do what is best for one’s firm and the duty not to risk serious harm to society.

To undermine the claim that executives have a duty not to engage in socially excessive risk-taking, it would need to be shown, in addition, that the duty to do what is best for one’s firm outweighs the duty not to risk grave social harm. But we need not pursue the inquiry even this far, because this objection’s description of the situation is inaccurate. The executive cannot have a duty to engage in socially excessive risk-taking deriving from a duty to do what is best for her firm. This is because engaging in socially excessive risk-taking is wrong.

An executive’s having a duty to do what is best for her firm does not give her a duty, or even a permission, to take *any* means necessary to promote the firm’s interests. The duty to do what is best for one’s firm must be understood as a duty to do what is best for the firm within the bounds of morality (and law). This is a perfectly general principle. We might say that a doctor has an obligation to do what is best for her patient. But suppose the patient needs a scarce drug, which some people have in their possession, but which no one is willing to sell (because they too need it). The doctor would not thereby acquire a duty to steal the drug from a person who has it on the grounds that “this is what is best for her patient.” Indeed, she would not even acquire a permission to steal the drug. Since stealing is wrong, the doctor cannot acquire a duty to steal on the grounds that this would promote an end that she has a duty to promote. The same goes for financial executives and their firms. Since it is wrong for executives to take socially excessive risks, they cannot acquire a duty, or even a permission, to do so on the grounds that it would promote an end that they have a duty to promote.
7. TWO PRACTICAL CHALLENGES

The objections to the agential narrative that I have considered so far are theoretical in nature. They question whether executives really do have a duty not to take excessive risks, and whether they really should take steps to ensure that they do not take such risks. I close by briefly considering two practical challenges to the agential view.

First, it might be objected that its recommendations are too vague. I claimed that financial executives should resolve not to engage in “socially excessive” risk-taking, and should further ensure that the rewards and penalties that they are subject to for risk-taking are neither “too large” nor “too small,” respectively. It might be said that these claims do not provide executives any meaningful direction as to how to behave.

In reply, some degree of vagueness is inescapable. This is because its source is the problem itself, viz., that executives sometimes take risks that are socially excessive. There is no bright line distinguishing risks that are socially excessive from risks that are not. Moreover, the vagueness of the problem confronts regulators, firms, and executives. But it does not follow that it cannot be meaningfully addressed. An analogy can be drawn again with driving. Driving cars is important to people, so people should be allowed to drive cars. But driving cars also exposes others to risks of serious harm. Cars are large and heavy objects that can travel at high speeds; they can destroy property and kill people. Cars can be driven, however, in ways that create more or less risk. Driving at 20 miles per hour, while fully awake, unimpaired by alcohol, and with both hands on the wheel creates less risk than driving at 100 miles per hour, while sleepy and drunk, and with feet instead of hands on the wheel. It makes sense to say to people: “You have a duty not to drive in ways that are too risky.” And: “You should take steps to ensure that you are not tempted to drive in these too risky ways, for example, be sure not to drink too much at the party.” And this is so even though we cannot say precisely what it means for a form of driving to be too risky. So it is with financial executives and risk-taking. They have a duty not to take socially excessive risks, and to take steps to ensure that they do not take them, but this is compatible with vagueness about what precise actions are required of them.

Of course, we may wish for, and work toward, precision in this domain. That is, we may wish to specify, and work toward specifying, the forms of driving that are too risky. Likewise, we may wish to specify, and work toward specifying, the sorts of financial risks that are socially excessive. My argument implies that executives should be part of this process. And when precise rules are formulated, executives should embrace them as their own duties, not as obstacles to work around in an effort to advance their interests. Moreover, executives must think about what steps they must take to fulfill these duties, reflecting on their own particular appetites for, and tolerances of, risk.
Second, it might be claimed that my recommendations are naïve. I have claimed that executives should resolve not to engage in socially excessive risk-taking, and should work with boards to ensure that their compensation packages do not incentivize such risk-taking. Because this requires making sure that rewards are not too large and penalties are not too small, it means doing something that is not in the executive’s self-interest. As a result, it might be thought, this will never happen.

Four points can be made in reply. First, as mentioned, abstaining from socially excessive risk-taking need not be costly for an executive. Executives should be working with boards to make their compensation less risky. This does not require lowering their compensation. Indeed, paying executives in a less risky way is compatible with paying them more.

Second, it is no objection to a conclusion that a certain behavior is required that people are unlikely to engage in it, because they prefer not to. The truth of a moral claim does not depend on its being embraced in action. In some situations, people will prefer to steal or lie, and will actually do so. Yet it is still correct to say that people should not steal or lie.

Third, people refrain from doing things that are in their self-interest all the time. It would be very easy for me to steal the packages that I see sitting outside my neighbors’ houses, and then lie about it. But I don’t. If I can refrain from stealing my neighbors’ packages and lying about it, then executives can refrain from socially excessive risk-taking. To this it might be replied that, while refraining from stealing and lying might not be in a person’s narrow self-interest—if I stole and lied, I would have more stuff than I do now—it can be in a person’s self-interest broadly construed. I may regard stealing and lying as bad and immoral, and as activities that are incompatible with my conception of myself as a good and moral person. But the same may be true of financial executives and exposing society to grave risks of serious harm. It may not be in an executive’s narrow self-interest to refrain from socially excessive risk-taking, but it might be in her self-interest broadly construed, in the sense that the executive may regard exposing others to grave risks as bad and immoral, and as activities that are incompatible with her conception of herself as a good and moral person.

My fourth reply to the charge of naiveté is that, in saying that executives have a duty not to expose society to grave risks of serious harm and should take steps necessary to ensure that they do not, I am not saying that only executives have this duty. A number of other parties, especially regulators, have it. My suggestion is simply that executives have it too. This has been overlooked in the current discourse about the causes of the financial crisis, and it should not be.

8. CONCLUSION

The world would like to avoid repeating the financial crisis of 2007–2009. To this end, much effort has been devoted to discovering its causes. According
to an existing environmental narrative, a major cause of the crisis was compensation packages for executives that incentivized socially excessive risk-taking. The solution to this risky pay problem, according to this narrative, is to change executive compensation so that it incentivizes less risk-taking. This responsibility falls primarily to government regulators, and perhaps also to firms. A natural outgrowth of this way of viewing the crisis is that, if anyone is to be blamed for it, then regulators and firms are.

While not denying the truth in this narrative, this article proposed a new agential one. According to it, attention should be focused not only on executives’ incentives but also on their actions. The bets that executives placed were influenced but not fully determined by their incentives. The agential narrative suggests that executives are open to blame for the crisis and, more importantly, have a responsibility to prevent future crises. They can do this in two ways: first, by resolving not to engage in socially excessive risk-taking, and second, by taking steps to ensure that their compensation packages do not incentivize such risk-taking. Taking the agential narrative seriously has implications for how society views executives and how executives view themselves. With respect to society, it helps us to see who is to blame for the crisis, and who shares responsibility for preventing future ones. With respect to executives, it encourages them to see themselves as stewards of the financial system in which they wield significant power, but in which everyone has a stake.5

REFERENCES


5. Versions of this article were presented at the Stockholm School of Economics in Riga, the Susilo Symposium at Boston University, and the annual meeting of the Society for Business Ethics. I thank members of those audiences, especially Xavier Landes, Nien-hê Hsieh, and Rosemarie Monge for valuable feedback. Thanks also to Tom Sorell for comments on a draft of this paper.
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Mind the Gap: Virtue Ethics and the Financial Crisis

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1. INTRODUCTION

The financial crisis has led to calls for increased regulation of the financial sector. In many respects this is uncontroversial because increased regulation should promote the behaviors we want to see, while limiting the behaviors we do not. This article takes issue with the idea that regulation, and guidelines, promote ethical behavior in the way that we want them to. First, judgment is often required to implement guidelines and regulations, which allows room for unethical behavior. Second, we want financial professionals to behave ethically even when there are significant incentives not to; so, verifying compliance with regulations and guidelines when such incentives are absent isn’t a good gauge of the ethical status of financial professionals.

The example of the valuation of the assets (net asset value; NAV) of hedge funds illustrates these issues well. There are many rules governing how NAVs should be calculated, and while we can verify that a fund is abiding by the rules, the ability to manipulate the NAV remains. Furthermore, the incentive to do so is often only present during a crisis (usually to understate losses). Therefore, verifying compliance during “normal” times is of little help in judging whether a manager will behave ethically when we most need him to. I first argue that the gap between compliance with regulations and ethical behavior is best filled by the adoption of a virtue ethics approach, as discussed by Albert Spalding and Alfonso Oddo (2011) and Johan Graafland and Bert van de Ven (2011). I then discuss the implications of adopting such an approach for the financial industry’s codes of conduct, such as the CFA Institute’s (2014) “Code of Ethics and Standards of Professional Conduct.” Adopting a
2. BACKGROUND: NAV CALCULATIONS AND WHY THEY MATTER

Investors can give their money to funds (including mutual funds, hedge funds, and exchange traded funds), and these funds invest this money in a variety of financial instruments, such as equities, debt, derivatives, commodities, and currencies. The NAV is the total value of a fund’s assets, minus any liabilities. It is usually divided by the number of shares that the fund has outstanding, so is expressed as an NAV per share. It is calculated daily, weekly, or monthly. The NAV is important because it tells an investor how much their investment in a fund is worth. It is calculated by taking the “fair value” of all the assets (usually financial investments) in a portfolio.

The Alternative Investment Management Association (AIMA) is an international organization representing the alternative investment industry. They publish a “Guide to Sound Practices for Hedge Fund Valuation” (2013) which outlines how fair value, and a fund’s NAV, should be calculated. The guide begins with the accounting standards and regulations (primarily the Alternative Investment Fund Managers Directive which came into force in the European Union in 2013), but extends these in various ways. In Europe, fair value is defined in the International Financial Reporting Standards as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants” (AIMA 2013, 45). The US Generally Accepted Accounting Principles adopt a similar definition, which is “the price that would be received to sell an asset or paid to transfer a liability” (AIMA 2013, 45). This article will not consider the valuation of liabilities: so liabilities will not be discussed further. Assets, according to both the US and European accounting standards, should therefore be valued at a price that a seller would receive for those assets.

In the case of listed equities—shares listed on major stock exchanges—determining fair value, and by extension calculating the NAV, is a relatively simple matter. The fair value of listed equities is the price at which other investors are bidding for those equities on a recognized stock exchange. Determining fair value is not so easy for other assets. The Financial Accounting Standards Board divides assets into three levels:

Level 1 assets: Fair value is calculated by taking quoted prices in active markets for identical assets. This includes listed equities.

Level 2 assets: Fair value is calculated by taking quoted prices for similar assets in active markets or quoted prices for identical or similar assets in markets that are not active or the use of inputs other than quoted prices included within Level 1 that are observable directly or indirectly. This includes listed equities that do not trade very often. If a security last traded two weeks ago the prices available for it today can vary...
widely, and may depend on the amount of the security an investor is trying to buy or sell. Brokers may give different prices for the security, and if so agreeing a fair value can be difficult.

Level 3 assets: Fair value is calculated by taking unobservable inputs which represent the entity’s own assumptions of inputs that approximate those market participants would use. This includes private investments, for which there is no market. The “entity” in this case is often the manager of the fund. (AIMA 2013, 45)

The NAV tells an investor what their investment is worth. For this reason, it is important that NAV calculations are accurate. For the majority of mutual funds and exchange traded funds, NAV calculation is a relatively simple matter, but for hedge funds this process can be considerably more complicated. Hedge funds often invest in Level 2 and Level 3 assets and the flexibility in pricing these assets gives rise to a conflict of interest for the manager of a fund. It is in the manager’s interests to have a higher NAV, because this suggests the fund has performed better than if it had a lower NAV.

In the European Union, the Alternative Investment Fund Managers Directive makes the investment manager responsible for calculating the NAV, and states that they should ensure that valuations are “proper and independent” (AIMA 2013, 7). The AIMA and the Standards Board for Alternative Investments (SBAI) augment the regulations and have both published recommended guidelines for fund managers. These guidelines make clear the importance of separating the function of managing a fund’s investments from calculating the NAV. In other words, the person (or people) responsible for making investments should not also be responsible for calculating how much those investments are worth. The SBAI state that hedge funds should appoint an independent administrator (a separate firm), which is responsible for calculating the NAV. However, the standards note that this is not always possible when assets are difficult to value. When this is the case, the SBAI suggest that the pricing function is separated from the management function within the firm. Furthermore, the valuation team should not be remunerated based on the performance of the fund. Where the fund management team is responsible for pricing, their input should be fully documented. It is also recommended that an external party evaluates the effectiveness of the valuation process. These guidelines are an attempt to ensure that the NAV is calculated in a reasonable manner (SBAI 2017, 10–14). AIMA also emphasize the importance of objectivity in NAV calculations, noting that an independent valuation expert can be hired to value investments that are difficult to price. AIMA also suggest that a fund provides investors with a document which describes in detail the way in which the NAV is calculated (their suggested format is in Appendix 4 of their guide).

The SBAI and AIMA guidelines have been revised numerous times since their original publication to reflect changes in legislation, and to strengthen the guidelines to limit the potential for mispricing. AIMA recommend that
the methodology for valuing assets is put into writing, and approved by a fund’s governing body (usually a board of directors). The governing body should also ensure that the valuation of assets is independent of the fund manager. Any involvement of the investment manager should be disclosed to investors. Where investment managers are involved in pricing assets, these functions should be separated within the investment management firm to limit the potential for conflicts of interest. The valuation of investments should be checked against independent pricing sources wherever possible. The SBAI and AIMA guidelines are therefore very similar, and emphasize accountability, thorough documentation, and the independence of pricing sources to limit conflicts of interest.

3. DUE DILIGENCE: ASSESSING THE NAV CALCULATION PROCESS

When an investor wants to invest in a hedge fund they usually go through a process known as “due diligence.” Due diligence means checking the information a manager has provided, including on the NAV calculation process. AIMA also provide a list of questions that should be asked, to help investors with due diligence. This section describes the process by which the NAV calculation methodology is checked.

The most important question is that of who takes responsibility for calculating the NAV and, specifically, obtaining prices for the underlying securities. The most straightforward case is when the administrator is responsible for calculating the NAV, and gets prices from a recognized exchange. This is the case when a fund is invested in Level 1 assets.

If a fund is invested in Level 2 or Level 3 assets, things become considerably more complicated. Ideally, these securities will be priced by the administrator. In some cases, the administrator can take quotes from brokers to price these securities. Brokers are intermediaries who quote bid and offer prices for specific types of securities. A potential investor will want to know that the administrator is going to brokers directly, rather than accepting prices given to them by the fund manager. However, in cases where there are few brokers quoting prices the fund manager is likely to have a close relationship with the brokers the administrator contacts. In theory, it is possible for the manager and broker to agree on a price for “pricing purposes.” However, the administrators will often price the same, or similar, securities for different funds, so they may notice significant differences between quotes for the same security for different funds and query these prices. A potential investor will also need to check that the fund manager has not directed the administrator to specific brokers; it is preferable for the administrator to pick which brokers to ask for prices. A well-structured and transparent pricing process, along with a responsible board of directors, and competent, independent administrator, should therefore considerably limit the scope for the mispricing of assets.

However, a fund may also invest in securities for which there is no readily available price. These include private investments, and bespoke
investments, including some derivatives, or very illiquid bonds. AIMA note that in these sorts of cases the investment manager may indeed have “the best insight with respect to the valuation of particular instruments” (AIMA 2013, 30). In these cases, the fund manager may price these on the basis of a model of the expected cashflows for the security, prices for similar securities, or other models. AIMA say “Such tools, common in private equity valuation, are based on sound economic principles. However, many of the parameters used in such models are subjective, and the resulting valuation can vary widely depending upon a particular investment manager’s perspective of the current market risk premia and the probability distribution of future cash flows” (AIMA 2013, 31) In other words, when a fund invests in Level 3 assets, there is flexibility in pricing some of these investments. A fund manager may, in good faith, calculate a fair value that turns out to be too high because they are optimistic about the future returns of the investment, or a fund manager might misprice such assets intentionally. The board of directors, and the appointment of an independent valuation expert, and transparency about the pricing process with investors all go some way toward mitigating this risk. A potential investor will also often seek to verify the reasonableness of the models used for pricing. They will also want to see a structured, and independent, process for mediating disputes over valuations. Additionally, a potential investor may ask for full disclosure of a fund’s portfolio so that they can check the availability of prices for themselves. Nevertheless, when dealing with these sorts of assets it is impossible to mitigate the risk of mispricing entirely. For example, an independent valuation expert is likely to be less familiar with the investments than the fund manager and will only be called upon to perform a valuation periodically.

To conclude this section, the AIMA and SBAI guidelines relating to NAV calculation are extensive and outline how best to ensure that the assets held by a fund are indeed priced at “fair value.” The due diligence process is extensive, and aims to mitigate the risk that a fund manager is mispricing their NAV. Nevertheless, these guidelines do not prescribe exactly how each investment is to be priced (this is an impossible task due to the evolving nature of investments) and, for some investments, room for judgment on the part of a fund manager remains. A fund manager may, therefore, be in compliance with all the guidelines, but use the room provided by this subjectivity to misprice investments in their portfolio. When faced with a fund investing in such assets, a potential investor will need to come to a conclusion about the fund manager’s trustworthiness. The second half of this article discusses how this is possible.

**4. DUE DILIGENCE IS INSUFFICIENT: DYNAMIC DECISIONS FUND**

Successful completion of a due diligence process does not ensure that a fund manager will remain honest. The critical question for an investor is whether a fund manager will remain honest when they have an incentive to behave
dishonestly. Verifying that behavior is ethical in “normal” times may not be indicative of how a person will behave when they have an incentive to behave dishonestly. This section uses a case study to illustrate this point. The third section of this article will discuss how to fill the gap between the guidelines and ethical behavior.

The Dynamic Decisions Capital Management was a hedge fund launched in London in December 2004. The fund was founded by Alberto Micalizzi, an academic from Bocconi University and Imperial College. Micalizzi’s funds performed well until the financial crisis. According to the Financial Services Authority (FSA; the UK financial regulator, which has subsequently changed its name to the Financial Conduct Authority [FCA]) Decision Notice, the Dynamic Decisions Growth Premium Master Fund suffered “catastrophic losses amounting to approximately 85% of its NAV in volatile conditions following the collapse of Lehman Brothers” (FCA 2012, 3). The Decision Notice adds that, rather than informing investors of these losses, these “losses were deliberately concealed from investors and other interested parties by Mr Alberto Micalizzi. ... In order to conceal the losses from investors, Mr Micalizzi entered into a series of contracts” (FCA 2012, 3–4). In other words, when faced with substantial losses due to the collapse of Lehman Brothers, Micalizzi tried to hide these losses from investors and reported an NAV that was inaccurate. Prior to the financial crisis there are no suggestions that Micalizzi was behaving in any anything other than an honest manner. Micalizzi was fined £3,000,000 by the FCA. This was reduced on appeal to £2.7 million in 2014.

The strategy of the Dynamic Decisions Growth Premium Master Fund was a liquid pairs trading strategy, which involved buying and selling equities on major exchanges. The portfolio manager (Micalizzi) tried to find two related stocks which were misvalued in relation to one another. He would then buy the undervalued one and short the overvalued one, on the assumption that the prices would move back into alignment. Because the misvaluations in cases like these are often small, the fund used leverage (borrowed) money to amplify returns. It was not, therefore, a fund for which it was difficult to calculate an NAV. The tribunal decision notice states that “In marketing material dated September 2008, for example, an overview of investment strategy and risk management policy spoke of stocks being accessed from a ‘highly liquid universe’ of the S&P500 and the EuroStoxx 600” (Micalizzi v. The Financial Conduct Authority 2014, 13). The fund did have an independent administrator, PNC Global Investment Servicing (Europe), which was subsequently subsumed within Bank of New York Mellon, and a board of directors.

Between 1 January 2008 and 30 September 2008, the NAV of the fund increased from $352 million to $437 million (Micalizzi v. The Financial Conduct Authority 2014, 15). In October 2008, the fund recorded a profit of $5.25 million on its investments. It had lost $84.94 million on the pairs trading strategy, but recorded a $90.2 million profit on a bond. In November and December, losses on the main strategy were similarly offset against gains on
a bond. The bond was an untraded bond which is summarized in the appeal documents in the following way: “we do not consider that the bond was at any time a genuine financial instrument capable of providing any financial return or capable of being converted into a commodity” (Micalizzi v. The Financial Conduct Authority 2014, 18). The financial regulator, the FCA, argued that Micalizzi knew from the beginning that the bond was not genuine, but the appeal court decided that he did not initially realize that it wasn’t genuine. This was why they reduced the fine from £3 million to £2.7 million. However, the appeal court also found that “any reasonable due diligence would have given rise to serious questions as to the genuineness of the bonds” (Micalizzi v. The Financial Conduct Authority 2014, 93). The appeal court decision document later states that Micalizzi showed a lack of integrity with regard to his “indifferent attitude” about whether the bonds were genuine or not (Micalizzi v. The Financial Conduct Authority 2014, 95). The structure of the bond has no relevance to the argument in this chapter so will not be reviewed in detail here. It is sufficient to note that, even if genuine, it would have been a Level 3 asset.

What is relevant for this article is that Micalizzi tried to hide the losses on his main strategy by investing in the bond. A number of purchase agreements were entered into on different dates to buy the bond, one of which was backdated. The appeal court document states that “In our judgment the only possible explanation for such backdating is that Mr Micalizzi, being aware of the losses that had been incurred on the main strategy, determined to conceal these losses by booking Purchase Agreement 1 at the end of October 2008, taking credit for the unrealized profit attributable to the discount from the face value of the bonds. This behavior was dishonest” (Micalizzi v. The Financial Conduct Authority 2014, 95-96). Micalizzi also misled investors about the NAV of the fund. He failed to communicate the losses on the main strategy to investors’ the appeal court summary document says “This conduct of Mr Micalizzi is more, therefore, than lacking in integrity. It was dishonest. Mr Micalizzi deliberately misrepresented the position to investors, and failed to provide them with information as to the true position, even when it was clear that they had been misled by the original information. Such conduct can only be dishonest” (Micalizzi v. The Financial Conduct Authority 2014, 97).

In summary, when faced with severe losses in his fund in September 2008, Micalizzi failed to inform investors of these losses. Instead, he invested in a bond, which was not genuine, and backdated part of this investment so that it offset losses in the main strategy. Both of these actions are unethical. However, it is not the case that Micalizzi was simply a man who habitually behaved unethically. The appeal court concluded that “This is, we accept, a sorry state of affairs for a man who, in other walks of his life, has apparently impressed with his integrity and honesty, as appears from references from third parties which Mr Micalizzi produced to us. But that cannot deflect from our clear findings that, at the time in question, and in connection with the
Fund and the Bonds, Mr Micalizzi’s conduct was dishonest in many instances and overall lacked integrity” (Micalizzi v. The Financial Conduct Authority 2014, 100)

What we have, in this case, is a person who acted ethically, or at least who we have no reason to suspect of acting unethically, until September 2008. Due diligence regarding the NAV calculation was made relatively simple because of the liquid strategy of the fund. A potential investor performing due diligence on his fund would, and presumably did, find that everything was in order. Nevertheless, when the fund lost money, Micalizzi acted unethically. The problem for investors is that due diligence, prior to September 2008, seems not to have provided any evidence about the likely future behavior of Micalizzi. To rewrite the familiar disclaimer on financial products: past ethical behavior is no guide to future ethical behavior.

One objection is that perhaps the due diligence process is unable to detect unethical behavior. This is not the case. The problems at the Dynamic Decisions Fund were first reported to the FCA as a result of continuing due diligence on the fund. The Directors of the fund asked KPMG to provide a risk assessment on the bonds in November 2008. KPMG informed the FCA of concerns that they had about the bond. Investors also raised questions, which led to meetings in February and March 2009 between Dynamic Decisions Capital Management and the FCA. The fund’s compliance officer resigned. By December 2008 one of the investors in the fund (Natixis) wanted to withdraw their money from the fund because, based on discussions with the fund manager, they believed, among other things, that the fund was in breach of its investment guidelines, and they were concerned about the level of the fund’s exposure to the bond (Micalizzi v. The Financial Conduct Authority 2014, 53–60). Natixis subsequently did their own research on the bond and concluded that the bond’s reported value was inaccurate. Natixis reported Dynamic Decisions to the FCA on 12 February 2009. Morgan Stanley, one of the prime brokers, concluded after a meeting with Macalizzi that the “relationship with the funds would be terminated as soon as it could be” (Micalizzi v. The Financial Conduct Authority 2014, 74). Furthermore, they alerted the administrator and fund’s directors to their concerns. Ongoing due diligence therefore did lead to the discovery of Micalizzi’s actions. While this is somewhat reassuring, it is of no consolation to investors who lost money in Micalizzi’s funds.

What can provide reassurance that a fund manager will behave ethically over time as regards the NAV calculation process? It appears that due diligence works, but can only discover what has already taken place. This example illustrates that what is of critical importance is how a manager will behave in difficult situations where unethical behavior is appealing. The next section argues that adopting a virtue ethics approach can go some way toward improving the chances of future ethical behavior, in the face of incentives to behave unethically.
5. VIRTUE AND THE CHALLENGE OF INVESTMENT FUND LOSSES

The previous section showed that Micalizzi was, initially, behaving ethically with regard to the calculation of the NAV of his fund. Due diligence on the NAV calculation process was not sufficient to demonstrate that Micalizzi would behave ethically in the future. In fact, he did not. The catalyst for this change in behavior was the losses his fund suffered after the collapse of Lehman Brothers. The question for those wanting to promote ethical behavior in finance is: How can we encourage ethical behavior when there are significant incentives to behave unethically?

The appeal court documents describe Micalizzi’s behavior as dishonest, and lacking in integrity. If we are seeking to encourage people to be honest we first need to understand what it is to be honest, and how an inclination toward honesty is affected by circumstances. Thomas Wells and Johan Graafland (2012, 338–39) define honesty in the following way:

At the heart of honesty is a commitment to impartiality, involving appropriate respect for the legitimate interests of others and the consideration of what an impartial spectator would consider right for someone in your position to say and do. Dishonesty consists in a self-serving partiality that systematically disrespects one’s interlocutors and relationship partners, that disrespects their autonomy by considering them in a purely instrumental way, for example, by failing to tell one’s commercial partners information they have a right to know. Honesty therefore goes beyond truth telling or “not-lying” to include such general qualities as sincerity and frankness which make trusting cooperation possible. But it also concerns the particular orientation and concerns that should follow the roles, relationships and promises that one enters into. One should become disposed to automatically consider the legitimate interests of one’s commercial partners—whether they be customers, employees, or collaborators—and provide the information and service that they have a right to expect.

This definition fits the Micalizzi case because his behavior failed to take into account the legitimate expectation of other investors that they would not be misled about the performance of the fund. Furthermore, an impartial spectator would have expected him not to attempt to cover up his losses. A further advantage of this definition of honesty is that it suggests a link between honesty and the ability to cooperate effectively, which is necessary for the functioning of financial markets.

Why do people behave dishonestly when they have not previously done so? Wells and Graafland argue that competitive markets reward honesty, because transactions between participants depend on mutual cooperation and trust. However, intense competition, with frequent replacement of market participants, can undermine tendencies toward honesty. This is because, when participants are trading with ever-changing counterparties, reputational information is difficult to establish and quickly goes out of date.
This does not appear to be the reason why Micalizzi behaved dishonestly. Although he may have faced intense competition from other funds, it is not clear that this competition became more intense, or that market participants were frequently replaced. It is impossible to know exactly what motivated Micalizzi to act as he did, and the remainder of this article will avoid speculation about his motives. Nevertheless, the idea that intense competition, or other situational factors affect whether people behave ethically, is worth exploring further. Mervyn King, the Governor of the Bank of England (King 2009), believed that the majority of people in the financial industry are “good men and women” but the problem during the financial crisis was “a matter of the incentives they face.” If situational factors make it more difficult to behave honestly, then there is a gap between what the rules and norms say we should do, and what we do in fact do when faced with situations that compromise our ability to behave honestly. Furthermore, there seems to be little we can do to mitigate this, except for trying to limit the occurrence of these difficult situations.

The literature on financial ethics suggests a number of situational factors that increase the propensity for unethical behavior. Behaving unethically in this context means behaving with disregard for the rules and norms that people know they should uphold, and which they have upheld in the past. People who behave dishonestly or unethically most of the time are a different problem. Miguel Alzola (2012) summarizes the literature on situational limits on honest behavior. He says that a person’s mood can affect their propensity to help someone in need, that we are more likely to help someone in need when on our own (as opposed to being a member of a group), that we are less likely to help people when we are in a hurry, and that we are more likely to cause a person harm when instructed to do so by a person in authority than acting on our own. In a business context, perceptions of a firm’s ethical culture, the attitudes of other employees and managers, informal incentives, and the effects of leadership can all influence decision making (2012, 381–83). Tae Wan Kim, Rosemarie Monge, and Alan Strudler (2015) discuss the phenomenon of “bounded ethicality,” which is when people’s capacity to act in accordance with their stated moral values is compromised by psychological limitations (341). They discuss an experiment which suggests that auditors were unable to estimate a company’s financial worth impartially, even when they were committed to impartiality and provided with a financial reward for being impartial. This study suggests that the role assigned to people can affect their impartiality. Although auditors were aware that their behavior was influenced by their role as auditor for a particular company, they underestimated this influence and did not sufficiently adjust for it (343). Ericka Lawrence and K. Michele Kacmar (2017) try to analyze the psychological factors that lead to unethical behavior. They suggest that job insecurity causes emotional exhaustion, which encourages unethical behavior. They argue that emotionally exhausted people act unethically either to benefit themselves, or to benefit the firm they work for. They write, “Such activities might include
providing false information to clients to ensure the organization meets its quarterly goals” (46). It is reasonable to suppose that during the financial crisis people working in the financial sector did feel that their jobs were less secure, and that they were also emotionally exhausted. These are the sorts of conditions in which we might expect people to behave dishonestly.

At first sight, these studies suggest that consistent honest behavior is difficult to achieve, particularly during stressful times. While people may behave honestly most of the time, and know that they should behave honestly, certain situations overwhelm their capacity to “do the right thing.” The only way out appears to be to limit the frequency of these situational factors. In other words, to limit emotional exhaustion and job insecurity. Unfortunately, this is unlikely to be successful because the financial industry, at least as it is at the moment, is characterized by quick decision making, frequent crises, and a stressful working environment. But there is another approach we can take. The following section argues that there are a number of strategies available for limiting the impact of situational effects by changing the way that people react to them.

6. BRIDGING THE GAP

Kim et al. (2015) say that, in most psychological studies of bounded ethicality, not all subjects act against their moral obligations. They say, “Bounded ethicality may indeed be a pernicious influence, but there is no reason to think that it is an influence that competent people can’t handle” (350). Their suggestions for handling such influences include “publicly sharing intended ethical choices with impartial third parties” and fostering the ability to recognize when we are operating in a difficult environment, and dealing with ethical choices in a more deliberate manner (349).

Alzola (2012) advocates developing “values” as a way to mitigate the situationist challenge. He says,

“If I value ‘honesty’ that entails that I want to be the sort of person who really wants to return the wallet I find in the street to its owner, even if the wallet is full of money that I desperately need. I do not want to be just someone who merely acknowledges a duty to return the wallet. To have a strong character is also a matter of cultivating the appropriate emotions. I will feel good rather than angry about giving the wallet back. Admittedly, even a person of strong character will be influenced by the environment. But a virtuous person will perceive situations correctly.” (386)

For Alzola, cultivating a virtuous character enables people to overcome negative situational influences. However, there is more to virtue ethics than promoting ethical behavior in response to specific situations. On the traditional, Aristotelian, conception of virtue ethics, living a virtuous life goes hand in hand with human flourishing. The traditional virtues are prudence, courage,
moderation, justice, and piety (Kamtekar 2004, 486). “Flourishing” is usually understood to mean “real happiness,” or the sort of life that is worth living. Developing a virtuous character is a necessary part of leading a flourishing life. This flourishing may also extend beyond the virtuous person him- or herself. Flourishing may extend to the recipients of virtuous behavior, or the community within which the virtuous person lives or works (Garcia 2009, 961) Virtue ethics is therefore at odds with the idea that judging which behaviors are ethical varies by context. David McPherson (2013) describes this as the “compartmentalization of morality into the various social roles we occupy whereby the norms that govern one sphere are viewed independently of the norms governing other spheres (286). Developing a virtuous character is part of living a flourishing life, and a flourishing life encompasses all aspects of that life.

Virtues are acquired through learning and habituation. If we repeatedly act in certain ways, “we become just by doing just actions, unjust by doing unjust actions, and so on” (Kamtekar 2004, 481). Usually under the guidance of someone who helps us to think about ethical dilemmas in a structured way, we begin to form virtuous habits. Learning to perform the correct action is insufficient; we must also become motivated to act virtuously, and come to believe that behaving virtuously is good for us. “To learn to do what is virtuous is among other things to come to take the appropriate pleasure in doing it” (Kamtekar 2004, 481). By learning to live a virtuous life, virtue ethics aims to give people the capacity to act ethically in unfamiliar situations. This is because habituation involves deliberating about the ethical thing to do in real, or imagined, situations.

The Association of Chartered Certified Accountants (ACCA) agrees that character has an important role to play in financial ethics, although they do not use the term “virtue ethics.” They write, “regulation can ultimately only be a backstop. It can make rules for behavior up to a point but the regulator is not in the room with the customer, the banker is and hence, it was argued, must have ethical underpinnings” (ACCA 2014, 5). In other words, while the regulator can make rules, the proper implementation of these depends on the good character of participants in financial markets. Importantly, this does not mean that a person will always succeed in overcoming these influences, but that they are committed to trying to do so. But how can such an approach be implemented in the financial sector? The following section discusses two approaches; the first makes recommendations for the institutions within which people work, and the second discusses ways in which individual virtues might be encouraged.

7. VIRTUOUS INSTITUTIONS

Geoff Moore (2012) argues that virtuous behavior needs to be enshrined in the institutions within which people work. He suggests that it is not enough to encourage individuals to be virtuous, and to apply these virtues at work,
because it is necessary that the institutional framework within which people operate enables the exercise of virtuous behavior. There are a number of ways in which institutional frameworks can “crowd out” virtue (aggressive competition and large bonuses are two oft-cited mechanisms), so the challenge is to provide frameworks that “crowd in” virtue. Moore suggests eight parameters.

First, the organization must be established with the aim of contributing to the good of the community. He notes that this entails continuous discussion about what the community’s good is, and how the firm can contribute to it.

Second, organizations must assess and develop the character of employees. Individual virtues will be discussed in the following section.

Third, organizations must design jobs so that employees have the opportunities to engage fully with the firm and its values. Deskilling of jobs, particularly at the lower end of the pay scale, is likely to reduce employee motivation.

Fourth, executive pay needs to be curbed. Of particular importance is the gap between the highest and lowest paid within a firm.

Fifth, decision-making processes should allow employees to have a voice, and certain groups should not be privileged over others.

Sixth, organizations must trust employees and limit monitoring of job performance. Moore notes that trust, and trustworthiness, are usually cemented by reciprocal relationships, which are likely to foster cooperation. However, this conflicts, to a certain extent, with the expectation that financial institutions will apply strict risk management, which entails detailed monitoring of the financial products that a firm is exposed to.

Seventh, organizations must encourage group identity. Moore notes that a sense of group identity has been shown to have a positive effect in social dilemma games involving cooperation.

Eighth, organizations must implement a transparent governance system. Pay scales and decision-making processes should be taken seriously. (Moore 2012, 309–311)

Graafland and van de Ven (2011) take a similar approach, recommending that financial institutions should be encouraged to pursue long-term strategies, and to put service to consumers before their own interests. Institutional reform that fosters greater cooperation, longer term horizons, and more equitable pay are likely to provide employees with environments in which it is easier to behave honestly. However, these suggestions do not get to the heart of the problem that is at the center of this article. How can we encourage honest behavior in those situations when dishonest behavior becomes appealing? A positive institutional framework can only help, but is it enough?

James Dempsey (2015) argues that members of an institution participate in the corporate culture, and therefore bear a degree of moral responsibility for the other members of that institution. His focus is on moral responsibility for corporate wrongdoing. However, his wider assumption is relevant here.
Institutions and individuals interact and therefore, in order to have institutions that foster ethical behavior, these institutions need to be composed of individuals who are committed to acting ethically. The ACCA highlight a particular problem, which they call “the muddle in the middle” which describes the challenge faced by those trying to change a firm’s culture. It isn’t enough to change behavior at the top of an organization—to be fully implemented, cultural change needs to happen at all levels (2014, 5). The role for individuals is clear from the list above. For example, assessing the ethical character of employees can only be done successfully by people who are themselves ethical, and ensuring that some groups are not privileged above others requires those intermediating discussions to behave ethically with regard to inclusiveness. The following section makes a number of suggestions. While suggestions for institutional reform are helpful, and may indeed encourage more ethical behavior, implementing these reforms, and perpetuating an ethical culture rests on the ethical character of those working in an institution.

8. VIRTUOUS INDIVIDUALS

To begin with, it is worth thinking about changes that could be made to ethical standards. The CFA Institute set the most widely recognized professional qualification for investment professionals. Their stated mission is “To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society” (see www.cfainstitute.org). A significant part of the course is devoted to ethics, and their “Code of Ethics and Standards of Professional Conduct” handbook is available online. The Code of Ethics states that members of the CFA Institute, as well as those preparing for exams, must

“Act with integrity, competence, diligence, respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the profession, and other participants in the global financial markets” (www.cfainstitute.org)

The other standards are worded in a similar way, outlining how members should behave, and what they should, and shouldn’t, do. The emphasis is therefore on behavior, rather than character. As this article has argued, it is often not sufficient to know what one should or shouldn’t do, because the regulations often leave scope for dishonest behavior, and because it is often difficult to do what we know we should do. One way to encourage behavior that is consistently ethical is to focus on developing a virtuous character. It is worth considering, therefore, whether the professional standards that people are held to should emphasize “the kind of person” they should aim to be, rather than the actions they should take. Robert Audi (2012, 288) notes that virtues enable people not just to do what should be done, but with the motivation to do so. He writes, “This motivational power of virtue is crucial for the question of what kind of person, or businessperson, one wants to be—and for the related question, How do I want to make my money?” (288, italics
The professional standards could be rewritten to say, “Strive to be the kind of person who always acts with integrity,” and so on.

Changing the wording in ethical standards is unlikely to have the intended effects without accompaniment by more practical changes. A number of these have been proposed. First, Kim et al. (2015) note that publicly sharing ethical commitments can increase the likelihood that people behave as they hope they will. John Boatright (2013) reviews the “Banker’s Oath” modeled on the Hippocratic Oath, which has been adopted in the Netherlands. He concludes that the oath cannot be a good guide to behavior because of the many difficult judgments that must be made by financial participants. Furthermore, taking an oath usually represents a commitment to be a particular type of person; this is the case for medical students and people appointed to public office (Boatright 2013, 143 and 145). However, bankers do not become bankers when they take an oath. Boatwright writes, “the professions and public service have many bright lines, while banking is full of gray areas. Even very lengthy, legalistic bank codes are incapable of giving unambiguous guidance on some of the most ethically problematic situations that arise in banking” (161). He adds that an oath, or code, can provide a starting point for developing sound ethical practice. In concert with other measures, such as a change in focus of ethical codes, it might be that a public declaration (or declaration when one joins a new firm), focusing on the kind of person one will strive to be, could foster an ethically sound environment.

Teaching employees to recognize when they are in a situation that is likely to hinder ethical behavior might be helpful. Learning to recognize when they are making decisions in a hurry, or when they are stressed, can help to slow down the decision-making process, and mitigate the pernicious effects of situationism (Kim et al. 2015, 349). Kim et al. note that doing this is difficult, but that the impact of situational factors is nevertheless not inevitable. Being able to discuss a particularly stressful situation or decision with a competent (and ethical) person at the firm might also help this process.

Teaching new employees, or indeed students at business schools, about real ethical dilemmas they may face may lead them to consider their actions more carefully when they face such dilemmas in the real world. Joanne Ciulla (2011) suggests that business ethics is taught through history. She argues that by adding historical context to case studies students will gain a better understanding of the recurrent problems people face in a business context, as well as a richer conception of the values and motivations that shape people’s behavior (342) For example, taking the case described earlier in the article, students in business ethics courses might find it helpful to think about the incentives faced by a fund manager whose fund has lost a lot of money, and about the possible positive consequences of dishonesty. Trying to imagine the pressures, and incentives to behave dishonestly, and the reasons why one should still act honestly, may help people to behave ethically if they find themselves under similar pressure. Discussing how to ensure that they behave honestly might also be helpful. Audi (2012) makes a similar point when he advocates taking a “narrative” approach.
to business ethics. This involves thinking about historically relevant cases, or imagined cases, in evaluating a current ethical decision (282).

Public recognition of individuals who do not succumb to incentives to behave dishonestly would also help to foster a more ethical environment. Financial regulators, such as the FCA in the United Kingdom, publish sanctions and impose fines on members of the financial community. However, it might be useful to highlight noteworthy cases of ethical behavior—for example, people who behaved ethically when they faced significant incentives not to, or individuals who refused to act unethically when ordered to do so by superiors, or individuals who reported unethical behavior. Audi writes that “Nearly everyone wants to be considered (for instance) honest, fair, loyal, just, sincere, kind, and generous. These traits should be developed in moral education” (2012, 287)

9. CONCLUSION

This article has argued that regulations, and guidelines, do not, by themselves, ensure that financial professionals behave ethically. This was demonstrated with the example of the NAV calculation process. For some assets, a level of judgment is required to determine the fair value of these investments. The scope for judgment leaves room for intentional mispricing of the NAV. Although investors usually perform thorough due diligence on such investments, these investors also need to form an opinion about the trustworthiness of the fund manager. Trustworthiness is of critical importance in the financial industry because financial professionals often face significant incentives to behave dishonestly. This was illustrated by the case of the Dynamic Decisions Fund.

The second half of this article argued that adopting a virtue ethics approach can bridge the gap between regulations and guidelines on the one hand, and incentives to behave dishonestly on the other. It argued that, while institutional level changes may be helpful, it is necessary that individuals working in the financial industry are encouraged to develop virtuous characters. A number of ways of doing this were reviewed, including changing the emphasis of the CFA Institute Code of Ethics, teaching employees and students about the ethical challenges they may face in their careers, and rewarding ethical behavior.

REFERENCES


Moral Responsibility for Large-Scale Events: The Difference between Climate Change and Economic Crises
BOUDEWIJN DE BRUIN

1. INTRODUCTION

The claim I defend in this article is this: With some few exceptions, no one can be held morally responsible for the global financial crisis that started in 2007. Or a bit more precisely: a received and a novel approach to individual moral responsibility, and two plausible candidates for collective moral responsibility, allow us to assign responsibility to only a small class of people or corporate entities.

This claim will strike many as prima facie highly implausible. Even though there is a fair amount of disagreement between people about whether an individual can be held morally responsible for climate change and environmental degradation (the car driver may or may not be responsible), there is very little disagreement about individual moral responsibility and the global financial crisis (at least some bankers and/or banks are, most people think, responsible). It is, therefore, important to qualify the scope of my claim and the argumentative strategies I use, as well as the underlying aim I have with this article.

To start with the latter, the bigger aim of this article is to see how various concepts of moral responsibility fare if applied to large and complex phenomena such as a financial crisis (or climate change). One might think that the literature on moral responsibility and climate change offers the tools needed to approach this generally. But as I show in this article, finance offers
a number of additional and puzzling complexities. To establish this, I choose two concepts of moral responsibility that reach different conclusion regarding environmental degradation, and show that they yield (almost!) the same conclusion regarding finance. I pit a fairly received concept used by such authors as Baylor Johnson (Johnson 2003) and Walter Sinnott-Armstrong (Sinnott-Armstrong 2006) against a contending approach pioneered by Matthew Braham and Martin van Hees (Braham and van Hees 2012).¹

It is perhaps tempting to retort that a far more plausible account of moral responsibility for large-scale events should zoom in on collective rather than individual responsibility. This is indeed tempting, but I don’t think it would help. I discuss two of the most prominent accounts (one based on plural subject theory, the other using the discursive dilemma), and argue that both fail for reasons that probably generalize to other accounts of collective responsibility.

Some disclaimers are in place. First, finance is extremely diverse, and I cannot hope to defend my claim by individually considering risk managers, attorneys, communications officers, traders, analysts, cashiers, depositors, mortgage borrowers, and so forth, or the teams or corporate entities they comprise. That is why I focus on key participants in the main causes of crises: traders in bubbles. Sadly, however, economists only have limited knowledge of the causes of bubbles and crises, and this makes any assignment of moral responsibility in finance tentative. Even though I only use well-corroborated models that are widely held in high regard by economists, progress in economics might force me to revise my arguments at some point.

Again, let me concede at the outset that there will be some exceptions to my claim: some individuals and teams will of course turn out to bear moral responsibility for large-scale events. If my argument didn’t allow for such exceptions, it would be vulnerable to an easy reductio; for clearly some mortgage brokers, credit rating analysts, central bank employees, economists, supervisory authorities, traders, house owners, business school professors and politicians (to name a few) lied or misled customers or salespeople, mismanaged funds, deliberately employed skewed asset-pricing models, failed to listen to potential informants, and manipulated markets. I certainly don’t want to deny the significance of these exceptions. I believe that much too little has been done so far to bring wrongdoers to justice. But their number is fairly small, and an analysis of their responsibility is unlikely to yield insights with broader philosophical relevance. That is why I don’t consider them here.

I proceed as follows. In Section 2, I consider individual responsibility. I briefly introduce the relevant factual background (economic models of the crisis) and the two competing conceptions of moral responsibility. Discussing two cases (of a private and an institutional investor), I show that the received approach holds no one responsible. Applying the novel account due to Braham and van Hees (2012), however, leads to the perhaps surprising conclusion that the private investor, rather than institutional investors, is morally

¹. Surely one might think that still other concepts of moral responsibility would lead to different verdicts. But I believe that my argument extends to many alternative concepts.
responsible for the harms resulting from a bubble’s bursting. In Section 3, I consider plural subject and discursive dilemma approaches to collective responsibility, and show that neither of them works. In Section 4, I critically examine the principle that wherever there is harm there is someone who must bear the blame, and I also consider the role of regulators and governments.

2. INDIVIDUAL RESPONSIBILITY

It is standard in economics to distinguish the run-up phase—the bubble—from the actual crisis. Using Hyman Minsky’s (1982) widely used terminology, the run-up phase consists of five “moments.” The first is displacement, where innovation changes expectations among investors. Innovation may be technological (think of the advent of the railroads in the United States and the subsequent railroad bond bubbles), but it may equally be financial innovation, often spurred by regulatory change (such as the development of securitization before the global financial crisis). Then, investors start buying new assets, leading to a boom. It is here, or in the ensuing third moment of euphoria, that the price of the assets will start surpassing their fundamental value; they will become “overpriced.” Some investors may already suspect a bubble, and may try to pass on the assets to “another fool,” as popular parlance has it, but only in the fourth moment of profit taking, rational or “sophisticated” investors will start selling their assets consistently, which sooner or later triggers a panic where everyone tries to dump the assets.

The subprime mortgage meltdown offers an illustration. Low interest rates, financial innovation (mortgage securitization in the form of asset-backed securities), and a global savings glut gave rise to a real estate bubble that started bursting in 2007. This is where the global financial crisis began. Crises are typically caused by small events. The subprime mortgage market amounted to only 4 percent of the entire mortgage market. How can a small bubble cause such a harmful crisis? The received answer is that small events cause crises in the presence of amplification mechanisms. A small event may have direct spillover effects owing to contracts between individuals or organizations “inside” and “outside” the event. If, for instance, a subprime borrower defaults on her mortgage and is declared bankrupt, some of her creditors (say, the plumber or vendor of a new sofa) may incur losses because they have to write off the debt. If a vendor happens to have done business with many defaulting subprime lenders, the vendor may have to file for bankruptcy herself too, which may in turn entail that she is no longer able to discharge her contractual obligations vis-à-vis still other individuals. And so on. But small events may also have indirect spillover effects. Here, the amplification operates through prices. If subprime loans start defaulting more than expected, the price of mortgage-backed securities decreases, perhaps even to the point of a so-called fire sale where they are dumped on the market. As a result, the financial position of owners of such securities will ceteris paribus decrease. If you own such securities, even if you are totally unconnected to the events that caused the fire sale, the value of your assets (and so your “net worth”) decreases.
Case 1: Selling Your House

You have been lucky enough to find a permanent job in a small university town that you really enjoy. You are renting a flat, but consider buying a house since you have become convinced that you want to stay in this place for at least the next ten years. You find a nice house at a convenient distance from where you work, which you decide to buy. After two or three years, you start noticing that the local newspaper publishes articles now and then that claim that house prices in your town (and country) have been too high in the last five years. They make clear that a significant drop in price is expected sooner or later. You find this plausible because two houses in your neighborhood were recently sold for about 20 percent more than you paid for your very similar house. You are concerned that in a few years from now your house may be worth less than what you paid for it. You realize that this would make it difficult or even impossible to move to a different place in the next five years or so, and even though you don’t want to do that, the mere thought that your options might be limited makes you nervous. After a third house in your neighborhood is sold at a high price, you decide to put your house on the market. It sells shortly after, 35 percent above what you paid for it. You repay your mortgage, save the rest, and rent a nice flat. Not even a month later, you read that house prices have started plunging. One of your former neighbors, an elderly woman that had moved into the neighborhood a decade ago, had to put her house up for sale as she was moving into a retirement home. She sold it at 80 percent of what she paid for it ten years ago.

Are you morally responsible for your neighbor’s losses?

Here are the key elements shared by the two concepts of moral responsibility I discuss in this article. An agent S is responsible for selecting action A, resulting in a state of affairs C, whenever three conditions are satisfied:

(i) Autonomy: S’s performing A must be the result of autonomous, voluntary, and intentional choice;
(ii) Causality: S’s performing A must be (part of) a cause of state of affairs C;
(iii) Alternative: S must have had the opportunity to select an alternative action B evading C.2

Your selling your house is certainly the result of autonomous, voluntary, and intentional deliberation. You considered the matter intensely and rationally. There was no force or compulsion, nor were you under the sway of any cognitive or behavioral biases when you sold your house. So, the first condition is unproblematic. It is less clear, however, whether selling your house was a relevant causal factor explaining why your former neighbor sold her house at a significant loss. An answer to that question will depend on the explanatory model (a question for the economists) as well as on the concept of causality (a philosophical question that the received and the contending approach to moral responsibility used in this article disagree on).

2. Surely, there are many different accounts of responsibility, but I’m going to ignore that here. See Tognazzini (2013).
Explanatory Model

Now the question about economics already causes some trouble. For an economist wedded to the view that economic behavior must be explained through models postulating rational agents only (maximizing their expected utility), bubbles seem impossible to understand. This is why: In a bubble, the price of an asset surpasses its fundamental value, a concept meant to capture the asset’s intrinsic value, typically defined as the sum of future cash flows the asset generates, discounted to the present. Each rational agent sees that no one wants to own an overpriced asset at a point in time \( t \) after which there will be no opportunity to trade any further. But then, a rational agent will argue, this asset cannot be overpriced at a point in time \( s < t \), because no rational agent would want to buy it for that price at \( s \). Reasoning backwards, it becomes clear that there won’t be any moment where an asset is overpriced, that is, exceeds its fundamental value.

Yet rationality doesn’t so easily absolve an agent from moral responsibility. More sophisticated models show that bubbles may arise out of the joint actions of rational and irrational agents (or even among rational agents only) if uncertainty is introduced. In such models, these bubbles arise if rational agents are uncertain about the presence and behavior of potentially irrational investors, or about whether the price of an asset is greater than its fundamental value (and also when they are uncertain about whether other rational investors are uncertain about these things). In such circumstances, rational investors may find it worthwhile to buy and hold assets during what they perceive as a bubble, at least for some time, because they may expect two sorts of investors to hold on to the asset for even longer: rational investors that were slower to realize the overpricing, and irrational investors that are unaware of the overpricing. Such investors, in sum, try to “calculate... the madness of people,” as Isaac Newton once said.

A simplified model of a bubble therefore looks as follows:

(i) The price of a certain asset \( M \) increases over time, surpassing its fundamental value at point in time \( t \);

(ii) At some point \( t + \delta_1 \), the first investor becomes aware of the fact that \( M \) is overpriced, until at \( t + \delta_n \) all \( n \) rational or sophisticated investors know \( M \) is overpriced;

(iii) The price of \( M \) continues to rise up to a point \( t + \varepsilon \) with \( \varepsilon > \delta_n \), with increasingly many investors selling \( M \), so that after \( t + \varepsilon \) it drops sharply, bursting the bubble. Here also unsophisticated investors will know about \( M \)’s being overpriced.

3. Estimating fundamental value is notoriously difficult due to uncertainty about the future cash flows and the interest rates to be used for discounting.

4. Formally, this is a so-called backwards induction argument based on common knowledge.

5. Newton is said to have remarked that “I can calculate the motions of the heavenly bodies, but not the madness of people,” but the attribution is disputed. There is no doubt, however, that he lost part of his fortune in the South Sea bubble of 1720.

6. This is closely inspired by the model of Abreu and Brunnermeier (2003).
But what explains why prices start plummeting at $t + \varepsilon$? Prices reflect supply and demand. My selling an asset marginally depresses its price. Up to $t + \varepsilon$, the effect of my selling $M$ is offset by a larger demand for $M$. At and after $t + \varepsilon$, however, rational investors (and later, we may assume, most other investors) attempt to get rid of $M$, depressing $M$’s price.\(^7\)

**Causality**

If I sold close enough to $t + \varepsilon$, it may seem that I contributed causally to the bubble’s bursting. But whether my contribution mattered for moral responsibility depends not only on the explanatory model, but also on what we take it to mean to make a causal contribution in relation to moral responsibility. Take, for instance, the received idea that for an agent to be a relevant causal factor, he or she needs to make a difference. Then, you are clearly off the hook, for you only sold one house. You didn’t make the difference: even if you had decided not to sell your house, the crisis would still have hit, and your neighbor would still have lost money selling her house.

The idea that being able to make a difference is necessary for you to be morally responsible underlies typical judgments of responsibility for climate change, and it may be tempting to apply these ideas to other large-scale events. Authors such as Johnson (2003) and Sinnott-Armstrong (2006) have argued that a person’s driving a car doesn’t make her morally responsible for environmental degradation. If their arguments are successful and applicable to finance, the conclusion is that you were not morally responsible for your neighbor’s losses.

But things are less straightforward. The model that explains the causal contribution an individual car driver makes to environmental degradation is the tragedy of the commons.\(^8\) Such tragedies arise when individuals overuse publicly available but scarce resources. In the original idea, developed by Garrett Hardin (1968), *common* (Lat. *communia*) refers to a patch of land belonging to all members of a certain community, where farmers graze their cows, but where increasing numbers of grazing cows ultimately deplete the resources. Negatively answering the question of whether the individual farmer (or car driver) can be held responsible for the depletion, Johnson and Sinnott-Armstrong argue that it is unreasonable for the individual farmer or car owner to hope that by switching to alternatives (fewer cows, public transport, etc.) she would help saving the common or the planet. Their individual marginal contribution is too small, the argument seems to say, to make a serious contribution.

Johnson and Sinnott-Armstrong have, however, recently been challenged by Braham and van Hees (2012). These authors argue that marginal contributions do not free you from responsibility.\(^9\) They take issue with the assumption that

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7. More precisely, it is a small time interval rather than an infinitesimal point in time.
8. The tragedy of the commons is a standard model of climate change. See, e.g., *The Stern Review* (Stern 2007).
9. It may seem their approach rides on an equivocation between being “partly” and “fully” responsible for something. I hope to show that theirs is richer and more complex, though.
for an agent S to be a causal factor for some state of affairs C, S has to have had a genuine alternative B that ensures that C does not arise. Arguing that that condition is too strong, Braham and van Hees propose to apply the NESS test (plus a criterion about Reasonable Alternatives that I’ll discuss shortly).^{10}

According to the NESS test, an agent S’s performing action A is a causal factor for C if and only if A was a necessary element of a set of conditions that are jointly sufficient to cause C.\(^{11}\)

It is not sufficient for you to be absolved from responsibility for C to claim that you had no opportunity to rule out C. You must show that there is an action available to you that would have avoided the outcome, had sufficiently many others concurred. A result of this is that, unlike Johnson and Sinnott-Armstrong, Braham and van Hees do find the car driver a causal factor for environmental degradation. The reason is that although his or her own decision not to drive a car does not avoid the negative effects of emitting carbon dioxide, it allegedly would if sufficiently many others adopted an alternative course of action (bicycles, public transport, etc.). Back to the case, then, following Braham and van Hees: that you sold your house is causally relevant to your neighbor’s losing money. The argument is this: As the above model makes clear, a bubble arises when sufficiently many people start selling overpriced assets. One seller doesn’t make a bubble burst, and two or three won’t burst the bubble either. But at some point, the added seller does make the difference. So a house seller is a necessary member of a jointly sufficient set of people selling their houses, thereby causing the housing bubble to collapse.\(^{12}\)

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10. The NESS test is due to Hart and Honoré (1985), but may go back at least as far as to John Stuart Mill. The originality of Braham and van Hees’s contribution is not so much the introduction of the NESS test. Rather what distinguishes their approach from others is that they have developed a general game-theoretic model that gives a precise account of moral responsibility in contexts in which your actions have consequences that depend on those of others.

11. With more precision, suppose each agent j performs action a\(_j\) with a resulting outcome C. Then, i’s performing a\(_i\) is causally relevant to C whenever there is a subset T of all agents satisfying the following conditions: (i) i is a member of T; (ii) whatever actions the members outside T select, if all members of T select a\(_j\), then C results; (iii) if all members of T stick to selecting a\(_j\) except for i, then the members outside T can select at least one combination of actions ensuring that C does not arise. If these conditions are met, whether or not T succeeds in causing C hinges on i.

12. It might look as though I implicitly assume that the tragedy of the commons is an adequate model of financial bubbles and crises. I don’t. But bubbles do share one important characteristic with such tragedies: an individual agent’s action leads to negative externalities on another agent’s utility, and these negative externalities are not internalized by the agent. Formally, if some agent i performs an action a\(_i\), and agent j performs a\(_j\), then the utility for j will be \(u_j(a_i, a_j)\), so that changes in i’s behavior lead to marginal externalities \(\frac{\partial u_j(a_i, a_j)}{\partial a_i}\). It is crucial to note, however, that in finance these negative externalities operate through prices rather than through physical pollution, as in the example of the car driver. This has important repercussions for the question of whether moral responsibility entails blameworthiness (or whether morally responsible individuals should be held legally liable for these negative externalities). It has, I believe, higher prima facie plausibility to derive a rights infringement from physical damage than from depressed prices, for instance.
You acted autonomously and intentionally, but whether you were a causal factor contributing to your neighbor’s losing money depends on the concept of causal relevance. Following the received view of moral responsibility, you are already off the hook. The ultimate judgment about moral responsibility following Braham and van Hees, however, boils down to the issue of the third condition concerning the availability of an alternative.

Generally, any alternative doesn’t suffice. The alternative should be reasonable, eligible, morally and/or legally acceptable, and so on. That you had an alternative is clear: you could have stayed in the house. Is that a reasonable alternative following Braham and van Hees? Let’s quickly go back to their analysis of the tragedy of the commons. By grazing cattle (or driving a car), I contribute to the depletion of resources. Braham and van Hees give examples of situations where despite my being a causal factor, I am not morally responsible because I didn’t have a reasonable alternative: “if not sending any of his livestock to the commons means that a farmer and his family will starve to death for lack of income or food, then it is not reasonable to demand that he do so” (Braham and van Hees 2012). Similarly, they say, it would be wrong to hold someone morally responsible for some amount of pollution if it were caused by them driving someone to the emergency room. “Frivolous” pollution, however, makes you morally responsible (Braham and van Hees 2012). They postulate, moreover, that what counts as (un)reasonable also depends on moral and legal customs: an action is unreasonable if it is ruled out by morality or law.13 In sum, for an alternative to be reasonable, it must not be an inadequate response to a situation that seriously threatens someone’s health or life; it must be acceptable given sufficiently widely accepted moral standards; and it must be acceptable given the laws that are effective in the situation at hand. A result of this is that if some action is an unreasonable alternative in a certain decision situation, it is highly unlikely that agents placed in such a situation will choose that alternative because they generally try to avert life-threatening situations, and to avoid breaking moral and legal norms.14

Back to the case. Although in your neighborhood three people moved before you moved, most of your neighbors didn’t sell their houses. The details of their decision situations may be a bit different from yours, but *grosso modo* there will be many similarities: most neighbors will, like you, have had no plans to change jobs or change places in the next five years or so. Most neighbors will have had some sense of house price developments, as many subscribed to the local newspaper. And all neighbors will, like you, have had some interest in avoiding a drop in their net financial position. So if you try to defend yourself by claiming that it would be unreasonable not to move,

13. I will here set aside the issue of whether this is always a plausible condition.
14. I should stress that this is an empirical claim. It doesn’t follow from Braham and van Hees’s definitions, but is consistent with them.
then you’ll have to explain why so many people in your neighborhood (as well as in many others) chose to select precisely that unreasonable action. I don’t think that this can be consistently done. So, the upshot is that if you adopt a received approach to moral responsibility (such as those of Johnson or Sinnott-Armstrong), then you are not morally responsible for your neighbor’s losses. With Braham and van Hees’s approach, however, you are, because you made an autonomous choice to sell your house. Selling your house was a causal factor in decreasing the price of the house of your neighbor. The alternative of not moving was reasonable. So you are morally responsible for the neighbor’s losses.

Case 2: Retirement Planning

Many people will find it decidedly counterintuitive to hold you morally responsible for your neighbor’s losses, and point out that the condition of causal relevance that Braham and van Hees introduce is just too strong. Consider, then, the following case.

You are a fund manager for AgriPension, a pension fund actively managing the retirement plans of farmers and other workers in the agricultural sector. It is your task to analyze the ICT industry, and buy and sell securities. You have bought shares in a number of mid-sized software companies developing social media and cloud computing solutions for individual and business customers. After some time, you start noticing that professional magazines and the financial press publish news that earlier expectations about innovation in this area were probably overblown. The development of social media and cloud computing is hampered by stricter forms of regulation that make it difficult for mid-size companies to compete with large companies. With hindsight, asset prices in mid-sized ICT have been too high in the past five years, and a significant drop must be expected sooner or later. You find this plausible because you have witnessed a rather steep rise in price over the past years, and you become concerned that in a few years from now these assets may be worth less than what you paid for them. You realize that this would lead to significant losses that would make it necessary to downsize pension payments. When you see that several other large investors are starting to sell mid-size ICT stock, you decide to get rid of all such shares the pension fund owns. Not even a month later, the ICT bubble bursts. The pension fund UniPension, responsible for the pensions of university personnel, turns out to be too late, and loses about three quarters of the value of ICT stock. University personnel face lower pensions as a result.

Consider the three conditions of moral responsibility: autonomy, causality, and alternative. This case and the previous should lead to the same judgment concerning the first two conditions. In both cases, you acted autonomously, and their causal structures are identical (they are both bubbles). If we follow the received view and say that the causality condition doesn’t hold, the conclusion should be that a fortiori divesting (selling) in the run-up phase of a
crisis does not make you morally responsible for the bursting of the bubble. To put it somewhat boldly: if an individual car driver is not responsible for climate change, then a trader isn’t responsible for the crisis. This is undeniably a conclusion that many people find unwelcome, or at least unexpected. I’m not going to spend more time on it, though, and want to continue by looking at whether Braham and van Hees challenge the incumbent view here, too.

So does accepting Braham and van Hees’s criterion of causal relevance commit us to the verdict that AgriPension’s fund manager is morally responsible for the lower pensions of university professors? We shall see the answer is negative. There is an interesting twist once we move to the case of the professional or institutional trader: the pension fund manager does not have a reasonable alternative.

**Alternative**

The first observation is that there are many different types of investors. I make the simple distinction between private investors, who trade for their own profit and trade rather small amounts of money, and institutional investors, who trade large sums of money to make profit for other people. Institutional investors work for insurance companies, university endowments, pension funds, mutual funds, and the like. The fund manager from the case is a clear example. Her main task is to ensure a particular return, given a level of acceptable risk that is determined by the purposes of the fund (in this case arguably the long-term ability to pay out pensions requires stability and fairly low risk). A fund manager’s activities are governed by legal obligations that are part of her contract with her employer, and reflect the content of contracts between her employer and their clients (the members of the fund). Some may argue that in addition to these legal obligations she is bound by moral obligations that arise out of the informational asymmetries between the fund manager and her clients, or from the relative vulnerability of the client, and so on (in the jargon, these might be the fiduciary duties agents have vis-à-vis the principals they work for).

Such fund managers buy assets for a variety of reasons. One reason is of course that shares may pay dividends. An often more powerful reason is to generate returns by buying now and selling later. Suppose you believe that XYZ stock is underpriced at the moment. If you buy now, then when others have also become aware of the true value of XYZ (and the price has risen compared to when you bought it), you have made a gain for your clients. But dividend and expected returns don’t exhaust the fund manager’s reasons. Every fund manager will also buy a variety of assets simply because she wants to diversify the portfolio. Diversifying decreases risk. It is better to have shares in two food companies than in one, and it is even better to have shares in these two food companies plus a pharmaceutical company, and so forth.  

15 The standard analogy to explain is that you shouldn’t put all your eggs in one basket (see, e.g., Fabozzi, Modigliani, and Jones 2009 for a textbook explanation). There are various other reasons for buying or selling securities, such as legal or moral proscriptions against owning stocks (or bonds) of certain characteristics. I ignore these factors here.
A fund manager will have to make buying and selling decisions concerning many different shares, and even though she will continuously monitor the composition (diversification) of her portfolio, it is practically impossible that she can avoid buying assets that, at a later point in time, turn out to be overpriced (and as a result may be part of a bubble). So the question we need to answer is: Which reasonable options are available to an investor once she discovers at $t + \delta_i$ that she owns an overpriced asset $M$? There are two things to do: sell them, or hold on to them.\(^{16}\) Selling them may precipitate a bubble’s collapse. This she certainly knows, and since she is an institutional investor she may even manage a sufficiently large number of shares for the selling of her positions in $M$ to have an immediate noticeable effect on $M$’s price. But as we learned from the earlier discussion of models of bubbles, the fund manager doesn’t know whether other investors know about $M$’s being overpriced. For all she knows, she may be early, average, or late. Of course she knows that if she is early, her selling $M$ now is much less likely to lead to an immediate collapse than if she were the last to learn. But equally, she knows that if she holds on to the asset until after the bubble has burst, she will not have made a contribution to the bubble’s bursting.

But is holding $M$ a reasonable alternative? Above I argued that if an action is unreasonable, we should expect to find only a few people selecting it.\(^{17}\) The converse is not generally true. There are reasonable alternatives that few people select. Still, what happens if one imagines an action’s being performed by many people or in many circumstances tells you something about its reasonability? Since the fund manager will have to deal with overpriced assets in the fund’s portfolio fairly regularly, we can consider what long-term strategies she (and other fund managers) have at their disposal. Or, to hammer this point home, if we restricted attention to the individual case, we would risk losing track of the fact that fund managers adopt investment strategies, and that we should ask whether, as a general rule, the strategy of holding on to assets in light of information of them being overpriced is a reasonable strategy.

It isn’t. An asset manager who never sells overpriced assets will in the majority of cases lose money—money that she is typically required by law to invest in the best interests of her clients. If clients learn that the fund is using the strategy of never selling overpriced assets, they will want to leave

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\(^{16}\) Quitting jobs is surely a reasonable available option, but its availability doesn’t show that the other options are unreasonable. If the only reasonable option available to a fund manager discovering she owns an overpriced asset is quitting jobs, financial markets would look very different. For if that is among the risks fund managers run, they would want to be compensated, or find employment in different industries.

\(^{17}\) You might wonder whether such things as large credit card indebtedness shows that many people are unreasonable after all. But Braham and van Hees’ definition of reasonableness is more permissive than such concepts as economic rationality and prudence. If my empirical claim holds true, an unreasonable action is largely an action that is obviously threatening a person’s existence, or illegal, or immoral. Taking on too much credit card debt is, then, a reasonable option according to this definition.
the fund. The fund will dry up. It doesn’t make sense to invest in such a fund, because one is likely to lose one’s money in the long run.

There is a further complexity. The fund manager is assumed in the earlier models to have gained knowledge about the difference between the asset’s price and fundamental value. But knowledge is hard to get. More often than not, managers will be confronted with competing bits of evidence, which it is difficult to sort out. They may have some reasons to believe M is overpriced, but there may also be evidence that the innovations in the respective company are so radical that it is almost impossible to estimate future cash flows. So is M really overpriced? If the fund manager announced that she will hold on to an asset once she gets some evidence that it is overpriced, she will probably stop trading, because there is very often at least some evidence backing any asset’s being overpriced. Then, she will no longer be running an actively managed fund, but a passive collection of shares, just like an index fund. Clients will walk away, because they will want to move their money to a much cheaper index fund. (They don’t want to pay fees to the fund manager for doing nothing.) That is why the general strategy holding on to assets that managers perceive as possibly overpriced is unreasonable for actively managed funds.

Back again to the case. You were morally responsible for the losses incurred by your neighbor when she sold her house, following Braham and van Hees. You weren’t if you accepted the incumbent account. On both accounts, however, the fund manager fails to be morally responsible for the decreased value of the pensions of university personnel. What general conclusion should this lead to?

A philosophical analysis of cases has the advantage of allowing for a high degree of precision in argumentation. But cases have the disadvantage that they may only capture a small part of reality. There is, however, considerable reason to doubt whether that is going to be the case here. Most economists agree that it is primarily through bubbles that crises start. The details of the bubbles may be very different, but their structure is the same. That is why I believe that the results from this section support the claim that moral responsibility for the global financial crisis among finance professionals is much smaller than many have thought.

3. COLLECTIVE RESPONSIBILITY

That holding individuals morally responsible for the global financial crisis hardly ever makes sense may perhaps be less surprising if we note that most people work in teams (or larger groups) rather than individually, and that such groups might be meaningful carriers of moral responsibility. If this is right, a more successful account of moral responsibility for the crisis may emphasize groups rather than individuals.

18. In many countries, pension fund membership is involuntary. This raises the additional moral question of whether the fund manager’s refusal to sell overpriced assets wrongs the fund’s members.
My aim in this section is to lower expectations about such an account. I focus on two popular ways in which collective responsibility has been applied to business. The first is based on Margaret Gilbert’s (1989) plural subject theory, which James Dempsey (in this issue) has used to argue that a banking culture prioritizing profit making over risk management should be held morally responsible for the crisis. The second takes the so-called discursive dilemma as its point of departure (Pettit 2007). A discursive dilemma is a situation in which a team selects a course of action (or brings a verdict on some subject matter) that its members do not individually support. If such dilemmas are common in finance, one might be led to think that collectives can be held morally responsible for outcomes for which individuals cannot.

Both lines of reasoning, however, are committed to making assumptions that are implausible on empirical and conceptual grounds; and while I could certainly choose other approaches to collective responsibility, I believe my arguments generalize sufficiently to undercut ascriptions of collective responsibility for the global financial crisis. Or so I argue.

3.1 Plural Subject Theory

Some definitions first. For a collection of people to constitute a plural subject there has to be common knowledge among them of the fact that all of them have openly expressed their quasi-readiness to engage in certain joint activities or to embrace, as a group, a particular set of values (Gilbert 1989). Common knowledge here refers to something being entirely transparent to all group members in the sense that all members know that it is the case, and also know that the others possess knowledge concerning it, that they know that they know it, and so on. Common knowledge is what typically arises when a member of parliament makes a statement during a meeting of a national assembly, where the architectural structure of the assembly room allows everyone present to witness not only the statement being made but also its being made “openly” in a way generating common knowledge among parliamentarians. The concept of quasi-readiness, in turn, captures the idea that someone is ready to perform her share of a joint action provided the others are quasi-ready too. When I would like to go see a film with you, I can express my quasi-readiness by saying such things as “Let’s go to Wall Street tonight”; and if you respond by saying “Yes, let’s do that,” a plural subject with respect to going to the cinema has been formed instantaneously. This is not a mere play of words; creating a plural subject creates joint commitments. If I don’t show up at the cinema, I have failed to discharge my commitment to perform my share of the joint activities of the plural subject.

19. Many other approaches to collective action exist, and I can’t do justice to all. Seumas Miller (2010) has developed an alternative account of collective responsibility. He applies this to a very specific kind of wrongdoing: corruption in finance. Corruption is ruled out by law in most countries, so it is relatively unsurprising that some corporate entities are collectively responsible for corruption (if one assumes that collective responsibility is a sensible concept). By contrast, I focus on activities that are neither illegal nor clearly immoral, in particular asset trading.
I have failed to live up to what I committed to when I expressed my quasi-readiness and you accepted my invitation to form a plural subject.20

Here are the main propositions I am going to reject: that within finance there are sufficiently many relevant groups constituting a plural subject collectively embracing the value of prioritizing profit over risk management; and that by habitually engaging in practices and activities revealing this value, people working in finance openly express their quasi-readiness to a joint commitment to embracing this value, thereby forming or joining the relevant plural subject. My argument is in two parts. First, I argue that common knowledge of the required sort is unlikely to arise. Second, I show that despite its initial plausibility, the claim that within finance profit comes before risk management is ultimately untenable.

The first part starts with the observation that common knowledge is unlikely to develop if people hardly ever interact. Your quasi-readiness to engage in certain activities and to accept joint commitments to embrace particular values has to be openly expressed. For sustained ascriptions of collective values, group members must have sufficiently many opportunities to create and reinforce their joint commitments to embrace these values. Now, most banks are large organizations with many branches and departments. Employees working at a bank’s local branches are mainly concerned with mortgages, small and medium-sized business finance, and other small-scale services. At a bank’s headquarter, traders, stock market analysts, accountants, macroeconomists, business experts, communications advisors, ICT staff, and many other workers are primarily focused on their own narrowly described roles. Consequently, most bank employees have very little interaction with each other.

This is underscored by the rigidity of most communication channels in banks. For instance, the design of a new financial product typically starts at the commercial side of the bank, only to move to the risk management and compliance departments at a later stage. A feedback loop generating common knowledge may result, but genuine cooperation between the commercial side of a bank and its risk management and compliance departments is fairly uncommon.21 If you insist on applying plural subject theory to finance, a more accurate way to describe a bank is to say that some plural subjects are committed to profit making, and others to managing risk. Moreover, there is no natural necessity to divide labor so strictly. Commerce, risk management, and compliance could interact more intensely. It is not clear, however, that even if we assume that in such a situation a genuine plural subject is established (with commitments vis-à-vis values), it would be one prioritizing profit over risk management. There is some empirical evidence that when organizational structures are more open, and when information concerning products, risks and compliance is shared more widely within teams or the bank as a whole, risk management gets higher priority not lower (Jorion 2009).

20. You may dispute whether such group concepts are necessary to explain my obligation to show up. It is not my purpose here to criticize Gilbert’s theory of plural subjects. But see de Bruin (2009).

21. Strict separation of various communication channels is sometimes required by internal or external regulation.
It might be objected that I am forgetting an important plural subject: top management, the real decision makers. Products are designed, risks assessed, and compliance checked, but it is still up to management to decide what to do. Surely, a board of directors is a much more likely prima facie candidate for plural subjecthood. Moreover, it may indeed seem that in some finance firms, top management was excessively focused on collateralized debt obligations, structured investment vehicles, and other potentially risky products, and some such firms did indeed suffer larger losses during the global financial crisis than firms with more restraint.

Before proceeding, let me first underscore the difficulties measuring a firm’s attitude toward risk management. Here is an instructive example. In 2007, the Swiss bank UBS lost $19 billion on mortgage-backed securities. As René Stulz (2008) notes, such a large loss doesn’t necessarily mean flawed risk management. A standard way of conducting risk management through value at risk (VaR) attempts to diminish risk by ensuring that potential losses exceeding a predetermined threshold magnitude will not manifest except in 1 percent of the cases (for commercial banks), and 5 percent (for investment banks). To find out whether VaR has been done right depends not on whether actual losses exceeding the threshold have manifested, but on whether they have manifested with higher than expected frequency. Assuming that there are 252 trading days in a year, excessive losses should be expected to happen during two to three days a year (or twelve to thirteen, if allowing for 5 percent exceptions). In 2007, UBS reported twenty-nine exceptions, where two to three would have been expected. It is that observation that supports the claim that risk management at UBS was flawed (Jorion 2009).

I now turn to my second point, and show why it is difficult to imagine a culture convincingly committed to prioritizing profit over risk management, even though individual managers may have had incentives to disregard risk management altogether. So my claim is that even if we admit that top management may figure as a plural subject, it would be too hasty to conclude that this shows that the directors of a firm form a plural subject in relation to the specific value of prioritizing profit over risk management.

It is instructive to compare the relationship between profit taking and risk management with that between profit taking and concern for the environment. The businessperson interested in profit at the expense of the environment is unfortunately a very real possibility. This is due to the fact that a concern for the environment is a genuine obstacle to making profit. Environmental care restricts the number of options you have, and as such potentially imposes costs on business. Profit making and risk management are in an entirely different relationship, however. The first and foremost principle in finance is that expected risk and expected return are related. If you

22. I’m not here denying the relevance of the long-term view in which a surviving planet earth is a necessary condition for conducting business. If a business destroys commodities needed to do business, concern for the commodities coincides with a concern for profit. The point here is that businesspeople caring for the environment will reduce the number of their options. Eliminating options never increases expected utility, and potentially decreases it.
invest in something more risky, you require that the expected return is going to be higher, because otherwise you would invest the same amount of money in something that bears less risk, but has the same expected return.\textsuperscript{23}

This means that you cannot sensibly discuss strategies to maximize (expected) profit without discussing risk. Inadequate risk management therefore on average leads not to profits, but to unacceptably many and/or unacceptably large losses, and that is why at the level of top management the importance of risk management should not be in dispute.

Now clearly bank directors may for all sorts of reasons ignore risk management. They may come from the commercial side of the firm and import a general dislike of risk managers. They may have personal stakes in ignoring these risks because of incentives created by erroneously designed remuneration packages. Or CEOs may falsely believe that their supposedly high level of expertise allows them to set aside the work of the Chief Risk Officer, who operates further down the board’s hierarchy. Even in such cases, however, there is no plural subject of the relevant kind. There is no joint commitment among directors to ignore or downplay the importance of risk management. Rather, one or more members are individually committed to, for instance, gaming the system for their own personal benefit. Such directors do not \textit{jointly} subscribe to a corporate goal (of prioritizing profit making over risk management). They probably assign no value to any corporate goals whatsoever. They are only interested in their own private monetary gains, and to the extent that this leads to harm, they are at most individually responsible.

### 3.2 Discursive Dilemmas

A device used more frequently than plural subjects in arguments about collective responsibility is that of the so-called discursive dilemma. Authors such as Philip Pettit (2007) and David Copp (2006) have used it to defend concepts of collective or corporate responsibility.\textsuperscript{24} Among the ambitions these and other authors have with the discursive dilemma is to gain deeper insight in collective responsibility in real-life cases. Pettit, for instance, starts an influential article with the tragic case of the \textit{Herald of Free Enterprise} disaster in the Belgian harbor of Zeebrugge. So, it is only natural to consider the potential role of the discursive dilemma in arguments about the global financial crisis.

The traditional setup of a discursive dilemma is one in which three members of a committee have to vote (yes or no) on three premises that are all necessary and sufficient for a policy to be implemented.\textsuperscript{25} The dilemma arises out of the fact that while individually each committee member believes that only two of the three conditions are satisfied, each condition obtains a yes vote from two of

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\textsuperscript{23} It is essential that in finance the risk of a particular asset is measured by its volatility rather than its expected payoff. Volatility is estimated by the standard deviation of historical returns of the asset.

\textsuperscript{24} It goes back at least as far as to Kornhauser and Sager (1986).

\textsuperscript{25} Pettit (2007) considers four propositions, but three are sufficient to get a three-person dilemma.
the three members. As a result, no member individually backs the policy, but each of the premises is backed by a majority of two. Since the decision rule used by the committee is stipulated to be such that it only requires majorities for the premises (a premise-based decision rule), the policy is implemented. Suppose now that some harm or wrong results from the policy’s being implemented. Who is responsible? Pettit argues that it can’t be the individual committee members, because each voted individually against the policy. So if you want to complain, you “can only blame the [committee] as a whole” (Pettit 2007).

Pettit’s conclusion can be criticized on several grounds, but I’m going to assume here that he is right, and that whenever such “voids” of individual responsibility arise, they show that collective responsibility is at least possible. In other words, it is particularly in situations such as the discursive dilemma that individuals lose, and collectives gain, moral responsibility. Yet I show that such situations are rare, particularly in finance.

The primary reason why discursive dilemmas are unlikely to arise in financial decision making is that most organizational decision making in real life is in boards, committees, or teams involving more subtle and fine-grained input from individual members than the binary yes or no vote. This point by itself is not decisive. Carl Andreas Claussen and Øistein Røisland (2010a) show that quantitative input generates discursive dilemmas just as easily. Their example is drawn from corporate finance. The board of a company votes on the question of whether to implement some policy. Each of the three members has personal estimates of two relevant measures: (i) the amount of money the policy would bring into the company (or more precisely, the discounted cash flow [DCF] of the project), and (ii) the costs incurred to start and realize the project (investment costs, IC). Given these two measures, the so-called net present value is calculated by subtracting the second from the first (NPV = DCF − IC). A project’s NPV is a crucial measure frequently used in all sorts of business decision making. As a general rule, if several projects can be chosen, the one with the greatest NPV must be chosen.

Here is how the members A, B, and C voted.

<table>
<thead>
<tr>
<th></th>
<th>Discounted cash flow (DCF)</th>
<th>Investment costs (IC)</th>
<th>Net present value (NPV)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>10</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>B</td>
<td>10</td>
<td>11</td>
<td>−1</td>
</tr>
<tr>
<td>C</td>
<td>13</td>
<td>12</td>
<td>1</td>
</tr>
<tr>
<td>Median</td>
<td>10</td>
<td>11</td>
<td>1</td>
</tr>
</tbody>
</table>

What NPV should the board “as a whole” assign to the project? This depends on two things. One is how the individual estimates of DCF and IC are aggregated into a board estimate. Claussen and Røisland use the median

26. One problem is that Pettit’s argument seems to presuppose a principle that if some harm happens as the result of human activities or decisions, there must be someone or something that can be blamed. This is dubious in the context of finance, as I briefly note in the conclusion of this article.
of the individual estimates. Then, for the board, DCF = 10 and IC = 11, as shown in the bottom row of the table. The other issue is whether the board calculates the estimated NPV of the project based on these two figures (a *premise-based* decision), or applies the aggregation procedure (in this case, the median) to the values of the NPVs induced by the three individual estimates of DCF and IC (a *conclusion-based* decision). Following the premise-based procedure, the board’s estimate would be NPV = −1, whereas the conclusion-based procedure would lead to NPV = 1. My argument proceeds on the assumption that whenever discursive dilemmas arise, the need to postulate collective responsibility arises also. So if Claussen and Røisland offer a plausible model of corporate decision making, to demonstrate collective responsibility for the global financial crisis only requires us to demonstrate one or more relevant discursive dilemmas. Yet there are two reasons why we should expect to find only a few such dilemmas. The first is that the example heavily depends on the fact that the aggregation procedure or decision rule is defined in terms of the median. As soon as the board switches to the mathematically more tractable mean (average), the dilemma disappears entirely.27 I do not want to deny that some boards may have reasons to aggregate individual votes using the median rather than the arithmetic mean. But it strikes me as highly artificial in most contexts.

But secondly, even if boards aggregated through the median, in many cases the difference between the premise-based and the conclusion-based estimate will be very small or nil. This has to do with an assumption that generally underlies the discursive dilemma: that no board member is a “dictator.” Consider a decision rule F that turns the individual estimates or judgments $g_1, \ldots, g_n$ of n board members into a board estimate or judgment $F(g_1, \ldots, g_n)$. Then, F is *dictatorial* if there is some $i$ such that $F(g_1, \ldots, g_n) = g_i$ for any combination of estimates $g_1, \ldots, g_n$. To assume that the decision rule isn’t dictatorial may have some plausibility in environments where decision making is heavily regulated.28 Board rooms are, however, a very different kind of environment. They are often dominated by a CEO that comes close to having dictatorial influence on the firm. Economists and business scholars have garnered sufficient evidence that the influence of CEOs on a number of output variables of their firms is much larger than we should expect if board decisions were the result of applying aggregate decision rules giving rather more equal weight to all board members.

Let me explain. Board meetings cannot in most cases be publicly scrutinized. But what can be done is to examine the extent to which particular characteristics of a firm’s CEO explain firm behavior. These characteristics involve the remuneration package the CEO receives, certain psychological traits (for instance, the “big five” core personality traits: extraversion, emotional stability, agreeableness, conscientiousness, openness to experience).29 What researchers consistently find is that these

27. For the (arithmetic) mean, it is true that the difference between two means equals the mean of the differences.

28. In another article, Claussen and Røisland (2010b) argue that this applies to monetary policy making.

29. See, e.g., Abatecola, Mandarelli, and Poggesi (2013) for a survey of the literature.
and similar CEO characteristics explain a fair share of the amount of risk a firm takes, its leverage ratio, the proportion of equity and debt by which the firm is financed, the interest rates the firm pays on its loans, its credit rating, and so forth.\textsuperscript{30}

I don’t have space to develop my criticism of the discursive dilemma much further.\textsuperscript{31} The plausibility of my claim is, however, underscored by an observation about law and regulation: a large part of corporate governance regulation is meant precisely to make decision making in boards less dictatorial.\textsuperscript{32}

In sum, many plural subjects may form in finance, but few will explicitly value prioritizing profit making over risk management. Moreover, collective decision making in finance may sometimes assume discursive dilemma form, but the paradox between premise-based and conclusion-based decision making doesn’t manifest itself but in rare occasions. Here, too, then the conclusion must be that with some few exceptions, no one is morally responsible for the global financial crisis.\textsuperscript{33}

\section*{4. MUST THERE BE SOMEONE TO BLAME?}

That (almost) no one is morally responsible for the crisis may not only strike some readers as implausible. It may also create some frustration: if no one is morally responsible, whom should we blame?

My conclusion leads to such frustration if you embrace the principle that if something bad happens as the result of human actions or decisions, someone

\textsuperscript{30} See Bernile, Bhagwat, and Rau (2017) for a striking recent example. This article shows that CEO experiences with catastrophes during early life predict the amount of risk their firms take. The article offers a neurological explanation for the mechanism through which particular disaster experiences determine a person’s attitude toward risk. For present purposes, this mechanism is unimportant. What is important is the observation that it is the CEO’s attitude toward risk (and not a “collective” attitude toward risk determined through discursive dilemma type decision procedures) that accounts for (the variation in) these output variables.

\textsuperscript{31} It is important to note that the existence of “dictatorial” CEOs is compatible with highly formalized decision rules. The inordinate influence of CEOs on managerial decisions may be exercised prior to voting in a discursive dilemma setting: whenever CEOs successfully persuade other members to follow their vote, a nondictatorial decision rule will still yield dictatorial decisions. Clearly, if the CEO has the power to persuade a majority of members, no “responsibility void” will arise. It is not difficult to show mathematically that, with increasing influence of CEOs on other board members prior to voting, discursive dilemmas are less likely to occur.

\textsuperscript{32} An interesting example here is the prohibition in the United Kingdom of CEO duality, that is, of one person assuming both the role of CEO and of chairman (in charge of the nonexecutive part of the board). In so-called two-tiered boards, an executive board carries out daily decision making, monitored by the nonexecutive or supervisory board. This model is popular in several continental European countries. In the United States and the United Kingdom, there is only one board, which has executive and nonexecutive members. The CEO is the main executive; the chairman the main nonexecutive. It’s easy to speculate that one-tiered boards offer more opportunities for dictatorship than two-tiered boards.

\textsuperscript{33} This brings us back to individual responsibility: CEOs wield great power over organizations, mostly for the good, but sometimes for the bad. Whether some of them are individually responsible for the global financial crisis depends on empirical details that I can’t go into now. But it would surprise me if after close inspection of these details no board member would have to be held responsible.
must be blamed. This principle may be plausible in a large range of homely cases. But it is entirely unclear whether it makes sense in the context of finance.\textsuperscript{34}

I will not come back to that and only deal with another objection. It is to the effect that I’m ignoring the institutional background of finance. Laws, regulations, and conventions may determine when the preconditions of moral responsibility hold, because they shape the causal connections and the available alternatives that market participants have. I am keenly aware of this, and I believe that observations about how moral responsibility is distributed given a particular institutional framework can inform debates about how these institutions might be changed. Here is an example. Bubbles and crises typically arise in situations where investors have suboptimal information concerning the fundamental value of assets. Some information is disseminated through price. A rise in a price of an asset indicates \textit{ceteris paribus} that expected future cash flows have increased. On a simple understanding, one investor obtains information about a new technology to be developed by a company. She expects the company to become more profitable, and decides to buy stock in the company, thereby marginally raising its price, and the more investors become aware of the news, the greater this effect will be.

For a price accurately to reflect the fundamental value of an asset, it is essential that all relevant bits of information are disseminated through price; and it is the institutional background that determines whether such information is available. Here is a slightly stylized example. Distinguish investors that are “optimistic” and “pessimistic,” respectively, concerning some asset. An optimist wants to buy the asset. A pessimist wants to sell it. Optimists can keep on buying the assets as long as they have money, but unless the pessimists can sell short, the possibilities for disseminating pessimistic views through price stops as soon as they have sold all their assets. (A pessimist selling short would borrow the shares from someone, and then sell them to an optimist. The pessimist would need to give them back to the lender at a specified point in time, but if the pessimistic scenario materializes, she will simply \textit{buy} them at a lower price than she first sold them, and then give them back to the lender.)

Short selling puts optimists and pessimists on an equal footing, and a result of this is that bubbles will be less pronounced—or are even prevented from starting. Yet many jurisdictions have strict rules against short selling, and a great majority of institutional investors have internal regulations against short selling in place (Hong and Stein 2003). In sum, regulators could ensure that fewer market participants become morally responsible for bursting a bubble by allowing pessimists to sell short.\textsuperscript{35} Sometimes deregulation does help.

\textsuperscript{34} See, for example Davies (2010).

\textsuperscript{35} Even where short selling is possible, it may still be hard for pessimists to bring their beliefs to the market. In such markets as real estate, art, wine, and so on. it is difficult to short sell, even if it is legal. A solution may be the introduction of indices. Gary Gorton (2010), for instance, argues that the introduction of the ABX index in 2006, an index for asset-backed securities, helped bring about the subprime mortgage meltdown. Had that index been there a decade earlier, there might not have been a bubble in the first place. A potential problem is, as Tom Sorell has pointed out (personal communication), that short selling pessimists may create pessimism in other market participants. The extent to which this harms them is, however, hard to determine on the basis of existing empirical research.
Let me turn back to the principle that if something bad happens someone must be blamed. I only want to discuss an example that, hopefully, helps casting doubt on its applicability to finance. The example involves swap agreements between banks the price of which exploded in the week after the collapse of Lehman Brothers in September 2008. A swap agreement is a contract to the effect that you and I swap cash flows. For instance, we could agree that I will pay you a fixed interest rate of 3 percent on $1 million, and that you pay me a variable interest rate on $1 million, amounting to the LIBOR rate plus half a percent. Similarly, we might swap our exposure to the risk that, for instance, a certain company goes bankrupt. If I have lent money to that company, it might be interesting to me to pay you some amount of money until some point in time in exchange for the right to be paid back (by you) my loan to that company in case it goes bust (plus remaining interest).

Anecdotal evidence has it that in the week after Lehman Brothers went bankrupt, the largest US investment banks bought credit default swaps that would protect them against the risk of other investment banks going bust. This made perfect sense. In fact, it would have been utterly irresponsible not to insure themselves against these dangers: if ever it made sense to buy credit default swaps, then surely it was so in the week that started the global financial crisis. But the aggregate result of this was that the market for credit default swaps exploded, exacerbating rather than dampening the turmoil. Whom should we blame? I believe we should accept that no one can sensibly be blamed. 36 37

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36. What should we then do? Sometimes regulation might help. As Darrell Duffie and Haoxiang Zhu (2011) observe, with complete information about all positions taken by all investments banks, all parties should have seen that “multilateral netting” would have eliminated their exposures to default risk. A simple example is when A owes $1 million to B, B owes $1 million to C, and C owes $1 million to A. If, say, B only knows her own situation, then B might need to take out a short-term loan from some party D to pay $1 million to C (and repay the debt to D after A has paid B). If these loans were common knowledge, multilateral netting would rule out the necessity of borrowing from D.

37. Thanks are due to Matthew Braham, Martin van Hees, Niels Hermes, and Martien Lamers for discussions informing this article. I owe particular thanks to Marco Meyer and Tom Sorell for extensive written comments on an earlier version.
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Blaming Ourselves
MARK HANNAM

The global financial crisis started in August 2007, peaked in intensity during September and October 2008, and came to an end at some point in the first half of 2009. The crisis comprised an interconnected set of financial, economic, and political events, which involved numerous individuals, private companies, public bodies, national governments, and international organizations. A decade later its consequences remain with us, with impacts across the financial, economic, political, and social sectors. Many of these impacts have been felt globally and most have been negative in the short term, including substantial falls in the value of wealth, significant reductions in economic activity, increases in unemployment and homelessness, reduced levels of social protection, growing distrust of politicians and policy makers, and a growing fearfulness about the future leading to a loss of hope.

Unsurprisingly, the breadth and depth of these negative impacts have led to the apportionment of blame. In the Western media, the blame process started well before the crisis was over and a simple but readily accepted narrative has now become standard. According to this account, “bankers”—a term that is used to denote anyone who works in the financial services industry—were the principal culprits, with financial regulators playing a supporting role. In brief, the standard account says that, motivated by greed and disregarding the likely results of their actions, bankers caused the financial crisis and must be blamed for its consequences; in addition, regulators, who previously lacked the tools to control the financial system, must now be given these tools, with new powers to intervene in banking activities and to punish those who misbehave. This standard narrative is well established in both the serious and the popular press, and in films, plays, and novels about the financial crisis.

If the repetition of simple morality tales that appear to make sense of a complex and consequential recent event is a well-established tradition in
our culture, so too is the debunking of such tales. Herodotus begins *The Histories* by listing popular contemporary accounts of why the Greeks and Persians fought each other, before setting out, at length, what he regarded as the real explanation; Homer could tell a good story but Herodotus would tell us the truth. In this spirit, I will argue that the tabloid—or Hollywood—version of the financial crisis is not a credible account. Instead, I suggest that the most plausible candidates for blame are the citizens of Western societies, who elected the governments that allowed the sources of financial instability to spread out of control. We are responsible and we should therefore blame ourselves.

I

In general, blame is assigned to moral agents for the consequences of their actions: blameworthiness requires culpability, which in turn requires both causal responsibility and moral agency.¹ There are exceptions to this general rule, but they are not relevant to my argument. Sometimes, in everyday speech, we blame natural forces for bad outcomes, but we do not really believe that the wind or the volcano was morally responsible for the damage it caused. Sometimes we blame moral agents for their dispositions as well as their actions and while it does seem right that we should hold moral agents responsible for some aspects of their character, it is not clear that this helps us to explain specific actions. The financial services industry might disproportionately attract and reward people who are greedy, in the same way that sport disproportionately attracts and rewards people who are competitive. These generalizations do not help to account for specific incidents of bad behavior in finance or sport, because persistent influences are not predictive of singular actions. Specific events are best explained by specific causes, rather than by general dispositions.

To be blameworthy is to be guilty of moral failure: we are justly blamed when we have behaved badly although we could and should have done otherwise. Since blameworthiness requires moral agency it is not clear that we can hold corporate bodies blameworthy for outcomes. We consider corporate bodies to have legal standing, which allows them to be fined for noncompliance with laws and regulations, although we cannot send a corporation to jail. We hold corporate bodies responsible without holding them blameworthy. In addition, we might hold an individual accountable for the actions of a corporate body in which they occupy a position of authority, even if they had no direct involvement with the actions in question, and we might fine or jail this individual for a corporate failure. In some cases, we both blame and punish the responsible individual for their actions, but in other cases we punish the responsible individual without blaming them. Moral responsibility is not the same as legal liability.²

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¹ For a recent survey of philosophical approaches to blame, see Coates and Tognazzini (2013).
² Hart (2008), Ch. IX.
Unlike cases where we assign legal liability to a corporate body or an individual, when we assign blame to someone for causing an unwelcome outcome we implicitly acknowledge some form of emotional engagement with them. This emotion might take the form of anger, contempt, or disappointment. Peter Strawson’s claim (2003), that we cannot maintain wholly objective attitudes to other people, but rely instead on reactive attitudes that take account of the attitudes and intentions of others toward us, seems appropriate in this context. Blaming is a moral action, not a detached scientific or legal description: we blame because we care.

The act of blaming also raises questions of entitlement. Who is best placed to judge whether someone else is blameworthy or not? Who has the requisite standing to express blame attitudes and in what circumstances is it appropriate for these to be expressed? We might think that the character and integrity of those who make assignments of blame have some bearing on whether we should take these assignments seriously; likewise, we might think that when blame is assigned to someone for an action, their subsequent behavior might mitigate the degree to which we think blame, while deserved, should be expressed. Context matters for appropriate assignments of blame.

Bringing these themes together, I make two suggestions regarding the conditions under which blame is justified.

1. Justifiably to hold agent A blameworthy for outcome X, we need to establish:
   a. that A was (at least partially) causally responsible for X, which requires an explanation of the causal sequence that led to X, plus evidence that A played a materially relevant role in that causal sequence (which might include A’s omissions as well as A’s actions); that A’s responsibility for X was an example of moral failure (whether intended or not); and
   b. that X was foreseeable such that that we can hold A culpable for the occurrence of X.

2. Justifiably to assign blame to A for X we would need to establish:
   a. that the actual (or potential) consequences of X were (or would have been) sufficiently serious that blame should be assigned; and
   b. that there is someone of appropriate standing to make the assignment of blame in a morally credible way.

Blaming, I suggest, is a five-step process by which we establish that A is causally responsible for X, that A’s acts or omissions implied moral agency, that A is culpable for X because the outcome was foreseeable, that X was sufficiently important to merit the assignment of blame, and that there is a person—the blamer—who has the credibility to assign blame to A. In the case of the global financial crisis I think that the first three steps are highly problematic; I will deal with these in Section II. Nonetheless, given the magnitude of the impacts of the global financial crisis it seems important that we find a means to assign blame in a credible way, which will be the subject of
Section III. Some concluding thoughts, setting out my rationale for holding the citizens of Western democracies responsible, will be offered in Section IV.

II

Causal explanations of major historical events are often problematic and frequently contested. For any given event, an account of what happened—the how—requires us to focus in detail on the particularities of the event, while an account of the causes of what happened—the why—requires us to step back to gain perspective on the generalities of the event.3 The origins of the Great War of 1914–1918, for example, remain a matter of dispute among historians. There is widespread agreement that the assassination of Archduke Franz Ferdinand and his wife Sophie, in Sarajevo on 28 June 1914, by the Serbian nationalist Gavrilo Princip, was the trigger for a series of ultimata between the major European nations, followed by declarations of war. Nonetheless, no one thinks that Princip alone was to blame for eight million fatalities and a further fifteen million injured. Moreover, at the time few foresaw the terrible consequences of the assassination and the subsequent military mobilizations. Kafka’s diary entry of 2 August 1914—“Germany has declared war on Russia. Went swimming in the afternoon”—sums up the mood of the day.4

If we consider the global financial crisis of 1929 we find not just disagreement among economic historians as to why it occurred, but puzzlement that it occurred at all. In the words of Harold James (2009, 47–48), “The 1929 crisis is a substantial curiosity in that it was a major event, with truly world-historical consequences (the Great Depression, even perhaps the Second World War), but no obvious causes.”

Equally puzzling is why economic crises happen so rarely. As Hyman Minsky remarked in 1982, quoted in Ferguson (2009, 165), “The most significant economic event of the era since the World War II is something that has not happened: there has not been a deep and long-lasting depression.”

Youssef Cassis (2011) identifies eight financial crises that have occurred since 1890, although not all of these were global in scope. These observations about the difficulty of explaining events (and nonevents) of the past century, for which there is voluminous documentary evidence and testimony, are suggestive of the difficulty of assigning blame for the global financial crisis of 2007–2009. If we lack a credible causal account,5 we cannot determine which agents made a material contribution to the outcomes; and if we cannot show that these outcomes were foreseeable to the participants, it is hard to establish culpability even if we could establish materiality.

4. See also Zombory-Moldován (2014).
5. I have written more about this, at Hannam (2013).
This general problem of causal explanation can be broken down into four component parts. First, if we consider the chronologies of the financial crisis, such as have been produced in official government inquiries, they tend to assume that we already know the causes that led to the crisis, that we already understand the causal connections between the various events that comprised the crisis itself and that it was possible to foresee the systemic risks to the financial system. These chronologies reflect widely held assumptions, but do not provide evidence for them. Prior to the crisis, judging by the decisions and commentary provided by regulators and policy makers, it was not evident which parts of the financial system were the most systemically important and which were the most vulnerable to failure. If, in 2006, the leading financial regulators in the United States and the United Kingdom had been asked to draw up a list of the top ten systemically important banks, it is most unlikely that either Lehman Brothers or Northern Rock would have been included; nor, if the list had been systemically important products, would mortgage-backed securities.

To illustrate this point, consider the first occasion that the term “too big to fail” was used to describe a bank rescue, which occurred in 1984 when the U.S. Federal Deposit Insurance Corporation (FDIC) decided to cover all the losses of both depositors and bondholders of Continental Illinois, then the seventh largest bank in the United States Continental Illinois bank’s financial problems stemmed, in turn, from its exposure to Penn Square bank, which failed in July 1982. Penn Square’s small deposit holders had been protected by the FDIC, but its larger institutional creditors, such as Continental Illinois, had not. As loan-losses were passed up the chain of financial intermediation, what started as a small-bank collapse in Oklahoma City ended with a national bailout to stem the growth of systemic risk in the US banking system. Cornelia Woll (2014, 69–71) notes that, given its size, few observers at the time would have considered Continental Illinois to be a candidate for a “too big to fail” policy. Nevertheless, the regulators judged that its degree of interconnectedness with other financial institutions elevated the risk sufficiently high that a bailout was justified. If few people thought that Continental Illinois was “too big to fail,” nobody thought that Penn Square was systemically important, nor that loan participation deals for the energy sector would be the trigger for a national bail-out of the banking system. In hindsight, everybody was wrong.

The first problem can be summed up as uncertainty regarding the impact of small antecedent events in a lengthy causal chain. If the last straw is responsible for breaking the camel’s back, as the English proverb claims, does this mean that none of the other straws are to blame? No individual straw is either a sufficient or a necessary cause of the camel’s injury, because it is only when the straws are aggregated that they produce the unwelcome outcome, and because if the camel had been loaded with feathers rather than straws, the same undesirable outcome would eventually have occurred. All

6. Details can be found here: https://www.fdic.gov/bank/historical/history/235_258.pdf
the straws, but especially the last straw, might think themselves unlucky to be blamed for the camel’s distress.

Our second problem concerns the real, as opposed to the apparent, importance of the various elements of the causal process. Which events were material, in the sense that they had a determinate impact on the evolution of the crisis, as opposed to events that were visible, in the sense that they had a determinate impact on the public’s perceptions of the crisis? The workings of the economy and of the financial markets are not easy to observe directly, especially for outsiders, and therefore some of the material elements of any given causal sequence might be inaccessible. Further, since some material elements of the causal sequence might be omissions rather than actions, we need a credible account of the likely counterfactual consequences if certain acts had occurred, when in fact they did not occur. What is evident is not always what is important and what is important might not always be evident, for which reason we need to think about the noumenal as well as the phenomenal features of the crisis.

An example of this second problem was the way in which television coverage of long queues outside branches of Northern Rock bank, in September 2007, was widely credited with causing a run on the bank, leading to its collapse. In fact, the bank had faced a wholesale-market funding crisis for several weeks, which it had reported to its regulator in mid-August, and attempts had been made behind the scenes to save the bank. The queues only formed after the Bank of England had publicly announced support for Northern Rock, having concluded that a private sector rescue was impossible. The queues of retail depositors did not cause the bank’s collapse; on the contrary, they were themselves caused by the announcement of state support for the bank (and the failure of the retail depositors to understand that their savings at Northern Rock were now guaranteed by the state). Additionally, many similar financial institutions in the United Kingdom—Bradford & Bingley, Alliance & Leicester, and Britannia—experienced the same problems as Northern Rock, but were dealt with differently by the regulators and policy makers in the wake of the Northern Rock bailout. In short, in standard accounts of the financial crisis, Northern Rock’s problems are wrongly described, regarding both the causal sequence that led the bank to collapse and the uniqueness of the predicament that the bank found itself in.

Third, even if we could establish which events were determinate for the evolution of the crisis and even if we could establish the direction of cause and effect during the crisis, we still face the problem that some major events are by nature composites, the weighted-average outcome of numerous individual events. The US housing market provides a good example: many commentators believe that falls in the value of housing across the United States made a significant contribution to the crisis, and that the principal conduit of risk from the housing sector to the banking sector was the market for mortgage-backed securities, which became illiquid. While this might be true in aggregate, it is not true in every

case: not all houses fell in value, not all homeowners had over-borrowed, not all mortgage-backed securities were flawed in design, and not all lost their value. The average outcome disguises a wide variation of individual outcomes.

Many houses did fall in value (albeit after a decade of strong gains) but there was no individual transaction that caused all the others to fall; taken in isolation each house sale was the outcome of a negotiation between the buyer and the seller, based on their own judgment about the value of the house and their desire or need to complete the transaction. These individuals were not trying to push up or pull down the overall level of the Case-Shiller housing index, nor were they working in concert with other buyers and sellers to achieve some other collective outcome. Many mortgage-backed securities fell in value, some deservedly because they were poorly structured and were collateralized with riskier mortgages than should have been the case; but some mortgage-backed securities that were well constructed and well collateralized lost value for no other reason than that the market became illiquid. In the absence of buyers, prices were marked down. These market-wide falls in value had a significant impact on banks’ balance sheets in the aggregate, and thus on the development of the financial crisis, but this collective outcome was not intended by any of the participants. Each bank was responsible for its own trading and pricing strategies, and market participants are forbidden by regulation from colluding in trading and pricing, for which reason it is hard to see how any given individual or institution could be said to have intended or orchestrated the collective outcome.

The fourth problem concerns the relative importance of inaction (an echo of Minsky’s remark, cited earlier, that events which didn’t happen might be as important as events which did). While every house that sold at a price lower than its estimated value might be said to have contributed to the fall in value of the housing market, it is not clear whether the responsibility for this outcome lies with the person who bought the house or with the many other people who decided not to do so. Weak prices are often the consequence of a relative lack of demand, that is, of fewer participants in the market. We would not be justified, however, in holding individuals responsible for choosing not to buy a new house, or choosing not to re-mortgage an existing one, even if the net effect of their collective inactivity was a slump in prices. Likewise, the temporary falls in prices of many mortgage-backed securities could be said to be caused by the absence of new buyers. For markets to function effectively they require both buyers and sellers, and when the buyers deserted the market, owing to fears that some mortgage-backed securities were poorly collateralized, all prices fell and potential sellers were left without counterparties with whom to trade. It is not obvious that we should assign responsibility for this temporary market failure to those who were left owning unwanted assets, as opposed to those who decided they no longer wanted to buy them.

I have described a series of four problems that together point to the difficulty of developing a convincing causal account of the global financial crisis of 2007–2009, or of any other major, historically important event (or nonevent). These
are (1) the problem of knowing in advance which events, institutions, and actions would later become systemically important without them being obviously important at the time; (2) the problem of distinguishing events that appear to be causes, but are in reality the effects of other, less visible causes; (3) the problem of composite outcomes, which are made up of numerous individual events, some of which have the opposite character to the composite outcome; and (4) the problem that many undesirable outcomes are the result of certain individuals or organizations doing nothing rather than doing something. On their own, each of these problems should raise a doubt about our ability to assign blame for the global financial crisis; collectively they should make us very skeptical.

If the likelihood of producing a credible, comprehensive causal account is low, then our ability credibly to assign culpability to individual actors and corporate bodies will likewise be reduced. Many of the individuals and institutions that have been blamed—notably in the popular narrative account of the global financial crisis, but also in some of the government-sponsored inquiries—have been blamed unjustifiably. What they did was often immaterial in impact and, given their knowledge at the time of their actions, was not irresponsible.

When Northern Rock was rescued by the British government in September 2007, who was to blame? Was it the wholesale-market funders, who stopped lending to Northern Rock because they worried that the slowdown in the US housing market would spread to the United Kingdom? Perhaps they were acting responsibly, seeking to protect the value of their investors’ cash. Was it the management of Northern Rock who, with the apparent blessing of the Financial Services Authority, pursued a growth strategy that was widespread among smaller UK banks that were formerly building societies? Perhaps they were taking risks they considered to be properly understood and well-hedged. Was it the Bank of England, which spent several weeks considering a private sector rescue for Northern Rock, but delayed until it was too late, and ended up issuing a guarantee of savers’ deposits? Perhaps they were worried that state intervention would create the expectation that other banks would be bailed out if they got into difficulty (which, in due course, came to pass). Was it the retail deposit holders who queued up to take their cash out of Northern Rock after their deposits had been guaranteed by the state, thereby increasing febrile public sentiment at a time when cool, rational behavior would have been more appropriate? Perhaps they misunderstood or distrusted the Bank of England’s guarantee, which was not well explained in the media at the time.

When the US housing market started to fall in May 2006 who was to blame? Was it the borrowers who took on too much credit at a price they could not afford to repay, hoping that rising house prices would allow them to re-finance their loans the next year? Maybe they were desperate to secure a place for their families on the housing ladder, and took assurance from the willingness of lenders to fund their house purchase that the risks were manageable. Was it the mortgage lenders, who issued loans to people who were unlikely to be able to repay, collateralized by property in a market that had
already tripled in price over the past decade? Maybe they were just respond-
ing to strong demand for new mortgages to be securitized by wholesale banks, who were better placed than they were to judge the fundamentals of the housing market. Was it the international policy makers who allowed banks to apply risk capital weightings of only 20 percent to their holdings of mortgage-
backed securities? Maybe they thought that financial assets secured by property would lower the risk profile of the banking sector, a view supported by data on the performance of collateralized versus uncollateralized loans over recent periods of financial history. Was it the investment banking teams that created ever more complex mortgage-backed securities, whose risks were difficult to isolate and quantify, except by recourse to proprietary models that investors did not have access to? Maybe they were bringing together willing buyers and willing sellers, as market-makers always have done, with the explicit blessing of their regulators, the credit rating agencies, and the international policy makers who assigned low-risk weightings to their innovative new products.

We do not know the answers to these questions. Some of these individuals and institutions acted in good faith, others did not; some were motivated by personal greed, others were not; some were genuinely unaware of the possible consequences of their actions, others had better foresight but chose to ignore it; some of these actions were evidently immaterial to the development of the crisis, others were highly material; some took their wider social and moral responsibilities seriously, and some did not. Aside from a case-by-case assessment of each decision to act and each decision not to act, it would be impossible to establish an accurate account of the motivation, foresight, and complicity of the various individuals and institutions involved, and impossible to determine the proportionality of the actions and outcomes for which they were (or were not) responsible.

Gavrilo Princip planned to kill two people and succeeded. He was blamed and punished for what he did but we should not hold him responsible for eight million deaths. No individual or institution aimed to cause the global financial crisis. Even though the actions of some individuals and institutions increased the likelihood of a crisis, it was neither the intended nor foreseeable outcome of any individual action (or inaction). Holding individuals responsible for what they did is justifiable; blaming them for an outcome which was neither expected nor foreseeable and to which their individual contributions were negligible, is not.

III

I recognize that this conclusion is highly unsatisfactory. The global financial crisis of 2007–2009 was a major event with many deleterious consequences. If it turns out that we cannot justly blame anyone for the crisis, we are rightly dissatisfied. In this section I will consider our need to assign responsibility for events that cause significant social harm. First, I want to make two comments about the scale of the consequences of the crisis.
In the standard account, the financial crisis required that Western governments “bail out” their failing banks, which cost taxpayers billions of dollars (or pounds, or euros) and led to significant reductions in public expenditure, often harming the most vulnerable in society. One reason why we might feel justified in pointing the finger of blame—and pointing it directly at well-paid employees in the financial services industry—is because we think the burden of outcomes was high, and fell disproportionately on the poor. The facts are less clear.

In the United States, the money lent to the banking sector to provide support during the crisis has been paid back in full; and more. When fees and fines are included, the US Treasury made a substantial profit out of the financial crisis, although it took significant risks with taxpayers’ funds to do so. The situation is different in the United Kingdom, where taxpayers face losses on investments made by the UK government in the Royal Bank of Scotland. In the light of the US experience, it is plausible to argue that this outcome was not inevitable, but is the result of inept management by the UK government. In other European nations, situations vary with some banking sectors more dependent on public subsidy than others.

The current budgetary problems of Western governments are primarily caused by state spending on welfare and public services growing faster than state income through taxation; and income through taxation has grown slowly in part because the financial sector has been less profitable in recent years. The taxes paid on banks’ corporate profits and bankers’ salaries made a significant contribution to public spending during the years before 2007. Today, bank profits and bankers’ pay are lower and so too are tax receipts from finance. At the same time, new rules increasing levels of bank capital have reduced the amount and type of bank lending to the wider economy, which has reduced the rate of economic growth. Public opinion appears supportive of the imposition of new regulations on the banking sector, but appears less happy to accept the lower levels of public spending that are implied by such regulations.

The costs associated with the global financial crisis are small by comparison with the costs associated with other economic problems which, because their impacts will be felt over decades rather than months, attract less public attention. The cost of funding deficits in public sector pension schemes in the United States, Japan, the United Kingdom, and other European nations over the next fifty years is likely to require public subsidy on a massive scale, far beyond the expenditure associated with the global financial crisis; so too the costs of responding to changes in the climate that are the consequences of the reckless over-consumption of fossil fuels. In these two examples, not only are the total costs to the public likely to be higher, but the causes of the problems are better understood, the likely outcomes have been evident for some time, and the connection between the actions of individuals and institutions and these outcomes is better established.

The consequences of the global financial crisis of 2007–2009 were serious but they were not uniquely bad. Dealing with the financial crisis will not be the most expensive challenge for Western governments during the first half of the
twenty-first century. Nonetheless, it remains true that many people believe the crisis to have been avoidable and its consequences material; therefore, they believe that those who were responsible should be made accountable. Providing some context on the real costs and their relative scale does not assuage the desire for someone to be blamed.

There are good reasons to welcome the desire of the public to hold individuals accountable for actions which have a significant negative impact on public life. While it is important to assign blame responsibly—as Angela Smith (2007) and Marilyn Friedman (2013) have argued—so too it is important for us as individuals—for our humanity, according to Strawson (2003), for our political subjecthood, according to Bernard Williams (1995), and for our sanity, according to Wolf (2003)—that we take responsibility not just for the actions we undertake, but also for the sorts of people we become through our actions. While there is a distinction between being a responsible person and being responsible for specific actions, it seems clear that one characteristic feature of responsible persons is that they take responsibility for their actions.

Our dilemma can be summarized in this way. The complexity of the global financial crisis makes it difficult for us to assign blame justifiably: we don’t know enough about the causal structure of the event or the intentions of the participants to establish blameworthiness. Yet we also recognize that for our own and our society’s well-being it matters that those who are responsible for socially significant outcomes with negative consequences are held accountable for those outcomes. Is there a way to resolve this dilemma?

One possibility is to broaden our conception of responsible agency to include not just the specific acts that I have done but also acts done by others in my community or group—those with whom I associate or identify—for which I might assume some form of responsibility. That I might consider myself responsible—in a moral rather than a legal sense—in some way for certain actions and outcomes that were done by others “like me” rather than directly “by me” is a common experience, the ethics of which are discussed in different ways by Joel Feinberg (1968), W. H. Walsh (1970), Herbert Morris (1976), Larry May (1992), G. A. Cohen (2006) and Iris Marion Young (2006). We do not need to agree with the Dostoevsky character who says that “everyone is really responsible to all men for all men and for everything” to think that we share some responsibility for more than just those actions that we ourselves have undertaken.

This notion of collective responsibility appears to sit uneasily with contemporary moral thinking, which holds that we are responsible for our intentions and actions, and to a certain extent for the intentions and actions of others with whom we choose to associate, but that we cannot be held responsible for associations and identities that we inherit, or which are ascribed to us by others. Today, many of us doubt that we are our brother’s keeper; we are sure that we cannot be the keeper for our wider community, let alone for our nation. Yet the idea of guilt by association—moral “taint” or “pollution”—has a long pedigree in human thought, and the suggestion that we share collective responsibility

8. For a discussion of this idea, see Appiah (1986).
for large, complex social events might be a useful residual version of this idea.

In the final chapter of *The Elementary Forms of Religious Life*, Émile Durkheim described a series of behaviors—piacular rites—common among the Aboriginal tribes of Australia, which included acts of sustained self-harm, that were performed in response to bad news, such as an illness, a death, or a bad harvest. The punishment of the living to atone for the dead appears to be irrational and unjustified. Durkheim argued, however, that these actions were demonstrations of social connectedness: they brought the group together after a traumatic event and re-energized those who remained with hope for the future. He wrote ([1912] 2001, 307).

When society encounters circumstances that sadden, anguish, or irritate it, it exerts pressure on its members to bear witness to their sadness, their anguish, or their anger through expressive acts. It imposes on them something like a duty to weep, wail, and inflict wounds on themselves or others, for these collective demonstrations and the moral communion they express restore to the group the energy that events were threatening to take away, and this enables the group to recover itself.9

Commentators have noted that Durkheim’s book, first published in 1912, appears to have been written in response to the outbreak of anti-Semitism in France at the time of the Dreyfus Affair (1894–1906). To explain the harm that contemporary French society had inflicted on itself, Durkheim made recourse to his interpretation of older traditions of social behaviour.

More recently, Karl Jaspers proposed a modern version of collective social responsibility in *The Question of German Guilt*, first published in 1947. Jaspers ([1947]2000) suggests four distinct conceptions of guilt, which equate to four distinct human failings. Criminal guilt occurs when we fail to abide by the law; we can be held accountable by the courts. Political guilt occurs when the political leaders and citizens fail to govern themselves successfully; they can be held accountable by more successful political forces, either internal or external to their community. Moral guilt occurs when individuals carry out actions, sometimes under instruction from others, which, regardless of mitigating factors, they know to be wrong; they can be held to account by their conscience, and the consciences of their close friends. Metaphysical guilt occurs when individuals fail to act to help their fellow humans in need, especially when injustices are committed in our presence and we do nothing to prevent or to protest the injustice; in this regard, Jaspers says, we are accountable to God.

The purpose of these distinctions is to allow Jaspers to argue that citizens can be considered liable for the consequences of deeds done by their state without also being liable for the criminal and moral guilt of actions done by some citizens in the name of the state. That is, when a fellow citizen has broken

9. Durkheim noted that fasting can sometimes be considered a form of piacular rite, which might explain the function of some of Gandhi’s celebrated public fasts, for example; Gandhi (2008, 224–25).
the law, the court should hold them accountable, whether they acted on behalf of the state or not; and when someone has behaved badly (but not illegally) their friends and their conscience should hold them accountable, whether they acted on behalf of the state or not; but when things go badly for our society because of a series of decisions by the government and its agents, then we must all hold ourselves accountable for these failings because the deeds of the state are the deeds of the citizens. The concept of political guilt excludes the option of saying “not in my name”: we cannot absolve ourselves of responsibility for the way our society governs itself even if we are not criminally or morally liable for the worst excesses.

Jaspers’s principal concern was, of course, the question of the responsibility of ordinary German citizens and soldiers in the aftermath of the Second World War. The International Court at Nuremberg had been established to punish major war criminals, but what about the rest of the German population? If they were not guilty of war crimes, did that mean they were innocent of any wrongdoing? Jaspers argued that he and his fellow German citizens were politically guilty: “the acts of states are also the acts of persons. Men are individually responsible and liable for them” (49); “all Germans without exception share in the political liability” (67); “we are politically responsible for our régime, for the acts of the régime, for the start of the war in this world-historical situation, and for the kind of leaders we allowed to rise among us” (72).

The courts would deal with the worst offenders, where clear evidence of law-breaking was available; and many other individuals would, in the solitude of their own homes, acknowledge their own part in the national tragedy. But this was insufficient. The German people needed to accept full political responsibility for the rise of the Nazi party and the terrible consequences for Germany, Europe and the rest of the world. In brief, “a people answers for its polity” (55).10

If Durkheim’s account seeks to provide an explanation in terms of function—“what is the purpose of these acts of self-harm?”—Jaspers’s account seeks to provide an explanation in terms of justice—“why is it right that we hold ourselves accountable for what went wrong?” Both writers recognize that for society to recover after a crisis, the members of society need to come together to share the task of recovery and renewal. Acts of collective contribution are necessary not only to settle questions of responsibility for the past, but also to take responsibility for making a better future. This insight offers us the best solution to our dilemma concerning the global financial crisis.

IV

The global financial crisis of 2007–2009 had, as its name suggests, global causes and consequences, but its epicenter was located in financial institutions domiciled in the Western democracies. Not all the factors that contributed to the crisis were in the control of Western governments: the US dollar is

10. Compare Albert Camus (1972), speaking in New York in 1946: “I have always believed that a nation is accountable for its traitors as well as for its heroes.”
the global reserve currency and US treasuries are the safe-asset of choice for investors all around the world, which means that in practice US policy makers can influence but cannot fully control trading in their currency and national debt. That having been said, many of the factors that contributed to the crisis were under the control of Western policy makers (at least to a certain extent) and while they could not always control the growth of risk taking in the private sector, they could have mitigated some of the consequences by implementing a range of fiscal and monetary counter-measures.

Further, and perhaps most importantly, most of the banks and other financial institutions that became engulfed in the crisis were authorized and regulated by public authorities in the Western democracies. As a general principle, idiosyncratic risk events can be blamed on the financial institution at the centre of the storm; recent examples might include Barings Bank (1995), Société Générale (2008), and UBS (2011). However, when systemic risk events occur it is less easy to assign blame because it is very hard to know in advance which events and which institutions might become systemically important. To the extent that anyone is responsible for preventing the growth and the spread of systemic risk, it is the regulators and policy makers who have oversight for the system, considered as a whole. By analogy, in the legal system, if an innocent person is sent to jail in a miscarriage of justice, we might blame the judge or jury in the case; but if numerous innocents are jailed owing to recurrent miscarriages of justice, then we are more likely to blame the legislators and those responsible for the governance of the legal system.

There are, therefore, grounds for saying that significant responsibility for the impacts that followed the global financial crisis should be assigned to the regulators whose job—in some cases, explicitly defined—was to prevent the growth and spread of systemic risk. Yet, if we consider what they might have done in the years leading up to the financial crisis to reduce systemic risk—imposed tough restrictions on bank lending to home owners, businesses and consumers, raised interest rates aggressively to burst the bubble in asset prices, tried to slow the rate of economic growth to make the West less attractive as a destination for savings from Asia—it quickly becomes obvious that these are not merely technical matters, but broader political questions about economic priorities. The regulators would probably not have been allowed to implement such policies (even assuming they had wanted to) because politicians in the West would not have dreamed of campaigning for slower economic growth, falls in asset prices, and tough limits on the availability of credit, because there are few if any votes to be won by policy commitments of this kind.

Mortgage borrowers, mortgage lenders, mortgage-backed security originators, investment bankers, bond traders, bank treasury managers, and other investors were all allowed to continue plying their trade, even as the level of systemic risk rose, because the regulators knew that the politicians would not countenance the economic and political consequences of a sharp slowdown in economic growth; and the politicians would not countenance a sharp slowdown in the economic growth because they knew that the voters would not
tolerate lower asset valuations and higher rates of tax and unemployment. The regulators did nothing to mitigate risk, because they knew that the politicians would not support them; and the politicians would not support them because they would not risk becoming unpopular with the electorate.

Does this mean that regulators, politicians, and voters are all equally negligent? Possibly, although it would be hard to establish the appropriate degree of reasonable foresight that should have been exercised by these different groups. Regulators, by virtue of their role, should be expected to be aware of the build-up of risk in the financial system; politicians, by virtue of their role, should be expected to listen to the warnings of regulators; and voters, by virtue of long experience, should be skeptical of politicians’ promises. Nevertheless, as I have made clear in this paper, it would have been difficult for anyone to foresee clearly what was about to happen to the global financial system prior to the summer of 2007. By the time the risks were evident, it was already too late.

If we return to the conditions under which blame is justified, which I set out in Section II, it is my view that it will always be very difficult for us to judge any specific individuals or institutions to be blameworthy for the global financial crisis. The causal sequence is too long, too complex, and, at times, too obscure to be fully understood. Even where some elements of the causal sequence are known, it is not always possible to assign culpability because many of the outcomes were not foreseeable and the intentions of many of the participants remain unknown. In the solitude of their own homes, some individuals might acknowledge to themselves their role in irresponsible behavior, but by the standards of evidence required for justifiable public blame it would be hard to say who these individuals are.

To be clear, where there is evidence that individuals have broken the law, I believe that they should be put on trial and, if found guilty, punished. This applies to the financial crisis of 2007–2009 just as it applied to the International Court in Nuremberg in 1945. However, none of the most egregious recent cases of financial crime—for example, that of Bernie Madoff—were material causes of the financial crisis. For which reason, I suggest that we should acknowledge that the crisis was a collective failure to manage the governance of the Western economies in a responsible and sustainable way: such an acknowledgment might, as Durkheim thought, allow society to renew itself. The only serious candidates for blame are the voting publics of the Western democracies: it is we who listened, credulously, when politicians promised year upon year of economic growth, rising house prices, improved public services, generous welfare, and lower taxes. Occasional dissenting voices raised doubts about the sustainability of this policy mix, but mostly we declined to listen. Despite the risks, we voted for these policies again and again and again.

Jaspers wrote that a people answers for its polity. It must also answer for the behavior of the financial sector which operates within a framework of rules that are set by the polity. We have no one to blame but ourselves.11

11. Thanks to Jonathan Wolff and Jake Richards for comments on an earlier version of this article. All blame for any residual deficiencies should be directed solely at the author.
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Mistakes Were Made: The Role of Catallactic Bias in the Financial Crisis

JOSEPH HEATH

1. INTRODUCTION

They say that one should never attribute to malice that which can adequately be explained by stupidity. And while this is no doubt a sound heuristic, when it comes to navigating the shoals of human affairs, many commentators on the 2008 financial crisis seem to have been making overly generous use of it. This is particularly true of those who seek to explain the crisis in its entirety as a consequence of stupidity or irrationality on the part of the major players (e.g., those who describe the erosion of lending standards in the sub-prime mortgage market as a consequence of the banks having “gone crazy”; or those who describe the enormous appetite for collateralized debt obligations (CDOs) as a consequence of the investors simply “not caring” about the quality of the underlying securities). There are two challenges confronting such explanations.

The first problem is that these accounts violate the principle of charity that governs the interpretation of intentional action. They try to make sense of events by saying, in effect, that the events made no sense. The difficulty that such interpretations encounter is that, the more they rely on the attribution of error to the agents involved, the greater the burden of proof associated with the interpretation, because of the ever-present possibility that one is simply misunderstanding the behavior in question. Thus, each new ascription of error increases the burden of proof associated with the corresponding interpretation, because it increases the plausibility, eo ipso, of any alternative explanation that is more restrained in its ascription of error, or that is able to make better sense of the behavior. There comes a point at which extremely
uncharitable explanations become self-refuting. The second major problem with the ascription of widespread irrationality to economic actors is that it ignores the incentives that would be produced by this irrationality, and what the likely effects of those incentives would be. One does not have to accept the efficient markets hypothesis in its more utopian forms to recognize that irrational behavior on the part of some will create buying opportunities for others, and that the net effect will tend toward the elimination of whatever anomalies were caused by the irrationality. (So, for instance, if it were truly the case that the banks had “gone crazy,” it seems that there should have been a lot more people lining up to profit from the opportunities this created—not just poor homebuyers, but short sellers and speculators as well.1) Thus, there is a tendency toward self-correction among groups, with respect to irrationality, that may not be present with individuals.

There are, of course, also commentators who err in the opposite direction, by insisting that everyone knew exactly what they were doing and that “animal spirits” played no significant role in the crisis. This is commonly the attitude among those who like to portray many of the key transactions as involving “smart” bankers dealing with “sophisticated” clients. Proponents of this line of thinking tend, therefore, to focus on the perverse incentives that these actors were facing, which led them to act in ways that were collectively self-defeating, despite being individually rational. (Examples would include not only the obvious deficiencies of the US regulatory system, but also the way that bonuses were paid at the investment banks, the structure of compensation of the ratings agencies, the opportunities for “regulatory arbitrage” that existed, as well as the moral hazard effects of the “too big to fail” conviction with regard to the major banks). Perhaps, the clearest representative of this tendency is Richard Posner, whose analysis of the financial crisis at times seems to boil down to the assurance that every so often these sorts of things happen, and there is not much that anyone can be expected to do to prevent them.2

In this article, I would like to explore some of the conceptual terrain that exists between these two extremes. My goal is to contribute to the construction of a somewhat charitable account of the financial crisis, one that acknowledges that genuine errors were made in the run-up to the crisis, but that stops short of attributing obvious or self-evident mistakes—much less outright stupidity—to the major players. In other words, I would like to say that important mistakes were made, but that some were more subtle than those posited by the standard “animal spirits” account. In particular, I would like to focus on a widespread error in the understanding of markets—that

1. As Michael Lewis shows, in The Big Short (New York: W.W. Norton, 2010), it was not all that difficult to short the US housing market, as well as the market for collateralized debt obligations. The question that Lewis’s book raises is why there were not more people selling the market short—and in particular, no major financial institutions doing so.

Mistakes Were Made

arises even in some textbook treatments—which I have referred to elsewhere as “catallactic bias.” I will argue that this error played a role in informing some of the poor decisions taken by both bankers and regulators. The bias in question involves a tendency to account for the benefits of all economic transactions on the model of the gain from trade achieved in a classic exchange relation. This gives rise to a fundamental misunderstanding of how insurance systems work, which can, in turn, lead to a failure to appreciate the full threat that correlation risk poses to the value of certain financial instruments. Such an analysis is able to explain why many people—first and foremost, Federal Reserve chairman Alan Greenspan—could have believed, in good faith, that the proliferation of derivative contracts that occurred in the run-up to the crisis was increasing the stability of the financial system, when in fact it was making it more fragile.

This is relevant to business ethics, because it speaks to the issue of blame. There was no doubt a great deal of bad behavior involved in the financial crisis. And yet the problems that generated the eventual crisis were so vast and systemic, it strains credulity to think that the crisis might have been averted, had people simply conducted themselves with greater probity. While the bad behavior ranged from the unethical to the illegal, there was also a great deal of “should have been illegal” behavior in between. The fact that it was not illegal is an ineluctable feature of the crisis. This raises issues that extend beyond the traditional ambit of business ethics, entering the field of political economy—of how we understand markets, and what the appropriate institutional structure for regulating marketplace competition should be. It thus serves as an important reminder that our understanding of ethical issues in business must be part of a broader theory of justice, one that specifies, inter alia, the appropriate division of labor between market actors and agents of the state.

2. RISK POOLING

It has long been understood that life in society “makes possible a better life for all than any would have if each were to live solely by his own efforts” (to use John Rawls’s phrase). The term “cooperation” is used, in the most general sense, to refer to the forms of social interaction that generate such mutual benefit. Yet some cooperative interactions are easier to understand than others. When two people combine their forces to move a heavy object, or to catch a wild animal, both the benefits of cooperation and the mechanism through which these benefits are achieved will be obvious to everyone, because they are perfectly tangible. In other cases, however, both the mechanism and the benefits are intangible. For example, it has long been understood that, beyond merely combining forces, individuals can also derive benefits from taking advantage of complementarities in their respective abilities and needs.

Plato’s central argument in *The Republic* was animated by the insight that some people are better at some jobs than others, and so the ideal city would be one in which each was assigned the role that was best suited to his or her particular abilities. Because each would then be in a position to make up for the weakness of the others, the whole would be greater than the sum of its parts.

And yet even Adam Smith, who was undoubtedly the most influential proponent of this idea, tended to focus on the tangible gains associated with the exploitation of complementarities—hence his emphasis on the increases in *production* achievable through the division of labor. It took much longer for economists to become clear on the benefits that could be achieved merely through improvements in the *allocation* of goods. It is reasonably apparent that if one person is good at fishing, while another is better at farming, then exchange between the two of them can generate cooperative benefits, by allowing each to shift from a system of autarkic to one of specialized production. The benefits of such an arrangement are easily discernible, because the creation of a system of exchange results in the production, over time, of a greater quantity of both fish and vegetables. And yet one can equally well conceive of a system of exchange developing under conditions of autarkic production, but where one person merely *likes* fish more than vegetables, while the other likes vegetables more than fish. By exchanging vegetables for fish, the two are able to achieve a *gain from trade*, but the benefit in this case is invisible. The total quantity of goods in the world remains the same; what changes is only that, thanks to the reallocation, the consumption of these goods generates more welfare than it otherwise would have. Because the benefit in this case takes the form of a pure welfare gain—and is, for that reason, invisible to the naked eye—it is much easier to overlook, and thus, to underestimate.

The development of marginalist thinking in the late nineteenth century made it much easier to conceptualize these gains, in part by introducing the now ubiquitous supply and demand diagrams, which provide a very simple graphical representation of the welfare gains achievable through market exchange. (Indeed, they provide a simpler and more intuitive way of representing gains in welfare than they do gains in productivity). This improvement in conceptual clarity paved the way for the proof of the First Fundamental Theorem of Welfare Economics, which shows that the value of a competitive market is that it makes it possible, in principle, for individuals to exhaust the set of welfare gains achievable through exchange. No less importantly, it was shown how partial equilibrium models, as well are more informal reasoning, can be used to demonstrate, under a more realistic set of conditions, that competitive markets will have the same tendency. The idea of finding a price level at which markets “clear” is precisely that of finding the point at which there are no longer any unrealized welfare-enhancing exchanges.

Given the enthusiasm that these new conceptual tools generated, it is perhaps understandable that an enormous amount of emphasis was placed on the welfare gains achievable through trade. And yet it is important to recognize
that the underlying mechanism—the exploitation of complementarities of need and ability—is not the only source of cooperative benefit, and indeed, not the only way of taking advantage of social interaction to achieve pure welfare gains. Indeed, excessive attention to the benefits of exchange can give rise to what I refer to as “catallactic bias,” which is a habit of mind that involves assimilating all cooperative benefits to the model of gains from trade. In some ways, early modern writers were less susceptible to this, perhaps because they lacked the relevant formal models of representation. David Hume, for instance, articulated quite clearly three distinct mechanisms through which cooperation can serve as a remedy to the “inconveniences” posed to us by nature: “By the conjunction of forces, our power is augmented: By the partition of employments, our ability increases: And by mutual succour we are less expos’d to fortune and accidents.” The first two are clearly recognizable as precursors to what modern economists refer to as economies of scale and gains from trade. The last is less familiar. It refers to the phenomenon of risk pooling, and the way that social interaction allows us to take advantage of the law of large numbers to produce cooperative benefits. What Hume refers to as “mutual succour” is at the core of what we now call insurance.

Perhaps, the best way of understanding the benefits of insurance, and distinguishing them from the benefits of trade, is to see that they do not rely on complementarities between individuals. Instead, insurance arrangements are based on risk pooling, which involves a group of risk-averse individuals who are confronting a particular gamble deciding to increase their welfare by agreeing to share gains and losses. The fact that they are risk-averse means that their expected utility from a particular gamble is less than the mathematical value of that gamble. (Consider, for instance, a game that gives a person a chance to win $10 if a coin toss comes up heads, nothing if it comes up tails. The mathematical value of this gamble is $5, and yet a risk-averse individual would not be indifferent between being given $5 and being given the opportunity to play this game. Precisely how risk-averse she is can be determined by figuring out just how little she would be willing to pay to play it). There is clearly an opportunity to increase welfare here—if one could take a gamble worth a certain amount and somehow convert it into a sure thing worth the same amount (or even somewhat less), one could increase the welfare that most people derive from it.

Risk pooling is one way of accomplishing this. The mechanism of cooperative benefit in this case derives from the law of large numbers, which states that for any particular gamble, the more times it is repeated, the closer the average result will be to the expected value. (For example, even though flipping a coin has the prior probability of producing heads of .5, it is rather unlikely that one will get exactly 50 percent heads in any sequence of coin tosses. Indeed, when one flips a coin ten times, the probability of getting between 40 and 60 percent heads is only 0.65. But if one flips it a hundred times, the probability of getting between 40 and 60 percent heads is closer

Another way of putting it is to say that, as a particular gamble is repeated, the frequency of any particular outcome will converge upon the probability of that outcome (a phenomenon known as “statistical stability”). Thus, when a group of individuals, each of whom is facing a particular gamble, agrees to divide up the gains or losses among themselves, they are each in effect exchanging the expected return from their own gamble for the expected average return from a larger set of gambles. Because the latter exhibits greater statistical stability its expected utility will be higher, even though its mathematical value is the same.

Consider the following, very concrete illustration. Imagine a small hunter–gatherer society, where five hunters set off into the woods each day to catch what they can. Returns are highly variable, and so each can expect to catch between one and ten kilos of meat per week. For simplicity, assume that each one hunts alone and there are no differences in skill. Each hunter will also be risk-averse, because he needs to catch at least two kilos per week in order to meet the subsistence requirements of his family. So even though the expected value of hunting is five kilos per week, each hunter would be willing to accept an arrangement that provided something less than that, if it allowed him to avoid the risk of coming home empty-handed. One way of achieving this is for the hunters to enter into a meat-sharing arrangement, the simplest form of which involves pooling everything that is caught and then dividing it up evenly (an arrangement that gives each hunter an allocation equal to the average of the returns of the five hunters that week). Figure 1 provides an illustration of such an arrangement, where the gray lines show the returns that each hunter achieves, hunting alone, over the course of fifty weeks, and the darker line shows what each would receive, were they to adopt the simple meat-sharing arrangement.

One of the striking things about this arrangement is that even though each of the hunters, working alone, falls repeatedly below the subsistence level of two, when the five of them pool their returns, even though there is considerable variation around the mean of five, no member of the group ever falls below the subsistence level. Visually, one can think of this in terms of how the risk-pooling arrangement “levels the peaks and troughs”—so that whenever one hunter is having a particularly unlucky week, some other hunter will usually be having a lucky week, and the two will to cancel each other out. Overall then, the insurance arrangement will reduce everyone’s chances of having a very good week, just as it will reduce everyone’s chances of
having a very bad week. But since the badness of a bad week is very much worse than the goodness of a good week, in terms of utility, everyone will wind up better off. (This is easy to show mathematically as well. If one assumes that meat consumption is subject to declining marginal utility, using a standard function like $u(m) = \log(m)$, where $m$ is the quantity of meat, then average utility of the returns over the fifty-week period to each individual hunter shown in Figure 1 are [.52,.56,.59,.55,.56], whereas the average utility of an equal share of those same returns pooled is .68. Thus, the value to the individual of the risk-pooling arrangement easily beats that of individual hunting—indeed, even if there were some sort of transaction cost associated with the risk-pooling arrangement, so that it only provided four kilos of meat on average, it would still dominate hunting).

It is important to emphasize that the system of cooperation, in this case, does not result in any increase in the actual returns to hunting—the quantity of meat caught remains the same. The insurance arrangement just increases the amount of welfare that individuals are able to achieve, given this quantity of meat. In this respect, it resembles the gains from trade that can be achieved through reallocation, in the sense that the benefits are entirely intangible. One major difference, though, is that in order for gains from trade to be possible, there must be heterogeneity of both goods and preferences. The benefits of risk pooling, by contrast, can be achieved even among individuals with identical preferences (and identical levels of risk aversion), even in an economy with only one good.

Finally, it is worth noting that insurance is a source of genuine economic value, even though it produces no tangible increase in anyone’s holdings. It is natural, when thinking about economic value, to focus on the physical outputs of production. And yet such outputs have value only to the extent that they satisfy demand, which is to say, only insofar as they increase welfare. What people are paying for, when they purchase an output, is really the anticipated increase in welfare that it affords. Thus, if one can find a way of offering increased welfare without increasing physical output, that will also have market value—even if, to an independent observer, it may seem as though one is producing “nothing.” It is important to be clear on this, because of the way that insurance companies are sometimes accused of trying to fraudulently “spin straw into gold,” or for having a business model that is a disguised form of gambling. Neither accusation is correct. Insurance arrangements really do produce value; it is just that the mechanism through which they accomplish this is somewhat esoteric.

3. CORRELATION RISK

The distinction between the two mechanisms of cooperative benefit—gains from trade and risk pooling—is clear when presented using simplified examples. When one turns to the real economy, however, things can quickly become more confusing. Partly this is because individuals who have different levels
of risk aversion can also enter into contracts—sometimes even called “insurance contracts”—that generate mutual benefit, but where the benefit actually takes the form of a gain from trade. Indeed, some early forms of maritime insurance were not actually risk-pooling arrangements, but just ordinary commercial exchanges that sought to take advantage of complementarities between individuals with different levels of risk aversion—what Ian Hacking has referred to as the “Lloyd’s of London” model of insurance.\(^6\) Trade by ship was historically a high-risk enterprise, because even though the rewards were significant, the loss of a ship at sea could be financially ruinous for most merchants. Thus the early Lloyd’s market allowed rich “names” to contract with merchants, agreeing to shoulder the losses associated with a shipwreck, in return for payment of a fixed fee. Under such an arrangement, the merchant was paying to offload the risk onto someone who was less averse to bearing it. This is quite different from the standard “mutual society” arrangement, where instead of trying to find a risk-tolerant sponsor, a group of equally risk-averse merchants would agree to pool their losses, so that if any one of them suffered a shipwreck, the others would “make him whole” out of a fund set aside for that purpose.

If we look at the contemporary insurance industry, however, it is easy to see that most firms in this sector are hybrid entities. There was a time when the standard categories of life, home, and automobile insurance were dominated by mutuals, which were, in effect, cooperatives owned by the policy holders (who would typically “overpay” their premiums, then receive a rebate at the end of the year, which constituted their profit share). This arrangement left the policy holders, as the owners of the firm, the residual risk bearers, so that if the company were to suffer unusually large losses these would be covered by reducing the rebate paid to policy holders. Many policy holders found this undesirable, and so in order to get rid of this “residual risk” many mutuals purchase “reinsurance,” which is essentially just a higher-order risk-pooling arrangement, where insurance companies in different areas pay premiums to create a pool of funds, used to indemnify any firm that happens to suffer unusually high claims. And yet reinsurance is not the only way of reducing residual risk. An alternative arrangement is to bring in equity investors, who for a certain rate of return will be willing to bear the residual risk (since their returns, and ultimately their investment, will be the first to be wiped out if the firm incurs large liabilities). The wave of “demutualizations” that took place in the insurance industry during the late twentieth century essentially involved firms adopting the latter form, so that they became standard investor-owned business corporations. An insurance company of this type is a hybrid then, in the sense that the risk pool among policy holders generates a cooperative benefit on the “mutual society” model, while the additional risk-bearing undertaken by shareholders typically produces a gain from trade.

on the “Lloyd’s” model. In principle, the two mechanisms of cooperative benefit are distinct, yet in practice, they are very difficult to disentangle.

The situation is further exacerbated by the standard expedient used by economists to model risk aversion (which I also used, in the previous section). This approach treats risk aversion as essentially epiphenomenal, a consequence of the declining marginal utility of money. Thus, for instance, a willingness to pay only $4 for a gamble that yields $10 in case a coin comes up heads, zero if it comes up tails, is explained as a consequence of the fact that, from a baseline of $4, a gain of $6 is not worth enough to the person to compensate for the potential loss of $4. The assumption here is that risk aversion is not a distinct preference (e.g., a reflection of the anxiety that people feel when confronting a gamble), but rather just a by-product of how one feels about money, or some other reward whose value dwindles as one acquires more of it. Another way of putting it is to say that, in the standard model, there is no such thing as risk aversion toward one’s own preferences. There is, however, not much empirical evidence to support this way of representing things, and there are alternative models that treat risk aversion as a distinct attitude toward gambles. The “declining marginal utility” model is used mainly for convenience, and because it allows economists to by-and-large ignore risk aversion when they go on to model other economic phenomena.

The problem with this approach is that it blurs the distinction between “being risk-averse” and “not having a lot of money.” Conversely, it suggests that as people, or organizations, become richer, they will become more risk-neutral. This can, in turn, generate a certain blurring of the distinction between different types of organizations, encouraging statements like the following: “We have assumed that there are ‘enough’ risk-neutral investors—a reasonable assumption in a world in which most stocks are in the hands of mutual funds, pension funds, insurance companies, university endowments, and other financial intermediaries that are the next best thing to the economist’s hypothetical risk-neutral person.” There is nothing wrong with this list per se, except that it encourages the perception that taking out a policy with an insurance company is no different from taking out a policy with any other well-financed institution, which, in turn, encourages the suggestion that what is happening is merely the exchange of a risk between a risk-averse individual and a risk-neutral institution. This can, in turn, generate the perception that “trading” risk and “pooling” risk are just different ways of describing the same thing.

In many cases such confusion is harmless, but in others, it may become quite pernicious. This is because circumstance may arise in which contracts

9. Nicholas Barr, The Economics of the Welfare State, 3rd ed. (Stanford, CA: Stanford University Press, 1998), uses these terms interchangeably (112). Later he describes a situation in which “in economic terms there is no possibility of spreading risk, and hence no gains from trade” (114).
that are based on risk pooling lose their value, while those that lock in a gain from trade remain unaffected. Specifically, risk-pooling arrangements are vulnerable to correlation risk in a way that transactions between risk-averse and risk-neutral agents are not. To see how this works, consider again the case of our five hunters and their meat-sharing arrangement. In the example presented in Figure 1, it was assumed that each hunter’s returns were independent, which is to say, completely unaffected by one another. Suppose, however, that the hunters interact with one another, so that when one is lucky, the others are more likely to get lucky, and when one is unlucky, the others are somewhat less likely to be lucky as well. (This could be due to anything, including an external event, such as animal migration patterns, or a social event, such as the hunters following each others’ trails in the woods). The correlation factor represents the degree of independence of the returns, with a 0 representing complete independence and a 1 showing perfect correlation (so each necessarily receives the same returns as the others). It is interesting to observe what happens to the risk-pooling arrangement as the level of correlation increases from 0 to 1. Figure 2 shows the returns to hunting, and of the risk-pooling arrangement, when the correlation is .25.

Visually, one can see the correlation in the tendency for the outcomes to cluster together, so that the gray lines begin to move more as one. One can see it also in the movement of the darker line, representing the average, which begins to look more chaotic. When one hunter is having a bad day, the chances that the other will have a bad day increases as well, with the result that on one occasion (day 22) the pooled returns even drop below the subsistence level. What is also noteworthy is that the difference between the utility value of each individual sequence of returns and the utility value of the equal share of the pooled returns declines (although it remains the case that the value of the risk pool remains higher than that of individual returns for each hunter, and so no one has an incentive to opt out of the meat-sharing arrangement). A further increase in the level of correlation, however, changes this.

Figure 3 shows the change in the meat-sharing arrangement when correlation rises to .5. Again, as the returns from individual hunting cluster together more closely, the line representing the returns from the risk pool becomes more chaotic, and on five separate occasions drops below the subsistence level. Furthermore, two of the hunters now do better by opting out of the risk pool entirely—in that the average utility level achieved from individual returns is higher than that associated with their share of the pooled returns.

![Figure 2. Risk-pooling arrangement with correlation .25.](image-url)
And finally, just for completeness, Figure 4 shows the meat-sharing arrangement with a correlation level of .75. At this point, it is easy to see that the risk pool no longer offers any sort of protection against the vicissitudes of fate and fortune, and so has become essentially worthless. It is important though to be clear about what has happened. Because of increased correlation of the underlying events being insured against, the economic value produced by the risk pool has disappeared. Even though there has been no change in the mathematical value of the gamble confronting each hunter, the law of large numbers no longer “works” to produce cooperative benefits, because instead of the hunters’ returns being determined by something like five coin tosses, the returns now resemble more and more the outcome of a single coin toss (which is what a correlation level of 1 would imply).

By contrast, consider what would happen if instead of trying to deal with the variability of returns by forming a risk pool, the hunters had instead addressed it by entering into exchange relations with a group of less risk-averse individuals. Suppose there were a group of “gatherers” nearby, who subsisted on a diet of tapioca root. Because this hardy tuber can be reliably located and is easily preserved, the gatherers are never at risk of starvation, despite having a diet that is rather poor in calories. Suppose then that each hunter made an arrangement with one of the gatherers, under which he would transfer to the latter a small amount of meat per week as payment, and in return, he would receive assurances that, whenever his returns from hunting fell below the subsistence level, he would be given as much tapioca from the gatherer’s stores as he needed to tide him over. It is not difficult to imagine circumstances under which such an arrangement would be of significant benefit to both parties. And yet, crucially, the benefits of this arrangement are entirely unaffected by correlation in the hunters’ returns. So while correlation destroys the value of the risk pool, it has no effect on a system based on exchange.
4. MORAL HAZARD

This analysis of correlation risk helps to explain why insurance arrangements are most successful when they serve to protect individuals from natural events or so-called acts of God. Crop insurance against hail is, perhaps, the purest example, of a highly localized, entirely unpredictable event that can nevertheless be extremely destructive. This gives farmers a powerful incentive to get together and create a pool of funds to indemnify those who suffer such losses. Indeed, it is not an accident that many forms of cooperative insurance were pioneered by farmers, precisely because they are exposed to so many potentially ruinous weather events (drought, fire, flood, frost, etc.). In these categories of insurance, correlation risk—that is, the risk that the occurrence of the events being insured against will become correlated—is very low, and when it is elevated (e.g., with floods), the problem can be addressed simply by expanding the risk pool either in space (e.g., to encompass those on the other side of a watershed) or in time (e.g., to create a pool of savings, so that one bad year can be offset by contributions from other good years). This is known as diversification, where one reduces the level of correlation of events in a risk pool by expanding the pool to include events that are unlikely to be correlated with those that are already in it. (This is to be distinguished from hedging, where one expands the pool to include events that are likely to be negatively correlated with those that are already in it).

Many of the risks that we are exposed to in everyday life, however, are not caused by nature, but rather by other people. In principle, there is no reason that such risks should not be insurable. The problem is that, because of the nature of human behavior, events that were initially uncorrelated may suddenly become highly correlated. For example, through imitativeness or social learning, seeing one person act in a particular way may lead others to act in the same way. There are also more complicated processes, such as those underlying an “informational cascade,” which “occurs when people with incomplete personal information on a particular matter base their own beliefs on the apparent beliefs of other” (there are also “reputational” and “availability” cascades). As a result, any risk pool that serves to protect individuals from losses that have a social origin may be exposed to a higher-level source of volatility in the form of correlation risk.

The perfect example of this is a bank run. In a sense, the organizational form of a bank is misleading, because at the core of the business model of a traditional deposit-taking institution there is in fact an insurance system. Firms and individuals often need to finance long-term investments, for capital goods that may take a long time to produce returns, and cannot be liquidated on short notice. Thus, they are interested in taking out loans with very long repayment terms. There are many other individuals with idle capital, who

would be willing to lend it out, but because of uncertainty about their own consumption needs, would like to be able to “call” the loan on short notice. One way of thinking about a bank is to see it as an institution that creates a type of insurance for these lenders. It takes a large number of small loans (i.e., deposits), then turns around and makes long-term loans (largely to investors, but also to consumers in the form of home mortgages). Thanks to the law of large numbers, it is able to offer its lenders the option of “calling” their loans at any time (i.e., withdrawing their deposits), comfortable in the knowledge that, if individual balances are largely uncorrelated, then withdrawals will be offset by new deposits, and so it will be possible to anticipate with considerable confidence the amount of money that must be set aside to cover redemptions. The bank then makes its money on the spread between the interest rate that it pays to depositors and the interest rate that it charges to borrowers. It is important to recognize, however, that the existence of this spread is a consequence of genuine economic value being produced by the bank. By pooling the funds of a large number of short-term investors, it is able to produce a smaller number of long-term loans, which are genuinely more valuable—as reflected in the fact that borrowers are willing to pay a higher rate of interest for these longer terms.

Unfortunately, the event that the bank is insuring against is ultimately a form of human behavior, namely, the desire on the part of small lenders to call their loans (i.e., withdraw their deposits). Thus, the classic bank run—where all depositors rush to withdraw their deposits simultaneously—is actually an instance of an insurance scheme being undermined by a sudden shift in the correlation level of the event that is being insured against. (Consider, for instance, the bank run scene in the movie *Mary Poppins*, which is triggered by a young boy whose father is trying to get him to start a bank account, yelling out “give me back my money!” This sets off a classic informational cascade, when a customer hears his cry and says “there’s something wrong, the bank won’t give someone their money,” leading her to demand her money back, leading the next customer to do so, and so on). What is striking about the bank run is that, under such circumstances, the basic business model of the institution breaks down entirely. In other words, under a certain set of social conditions, it is no longer possible to produce economic value using the “retail banking” model. Indeed, whatever value the bank had created disappears—which is, of course, why the customers want their money back. The only thing that can save the bank is the expectation that the form of behavior that has suddenly become highly correlated will at some point become uncorrelated again.

With these ideas in mind, it is noteworthy that among the central “moving parts” in the 2008 financial crisis were no fewer than three distinct types of insurance or of insurance-like arrangements. This was obscured by the fact that none of them were explicitly called insurance, but it is still not difficult to identify them. The first was obviously banking, and in particular, the non-traditional forms that developed in the so-called shadow banking sector, such
as the use of short-term “repo” loans to finance the activities of the major investment banks. The second important type of insurance implicated in the financial crisis was built into the mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) that were being sold. Loan obligations were not just being securitized and sold, the securities were “tranched,” typically into three broad classes. Rather than distributing out losses equally among all investors, the first batch of losses (say, 5 percent of the total) were imposed on the lowest, or “equity,” tranche. Only if losses exceeded this amount would they then be applied against the second or “mezzanine” tranches. The higher or “senior” tranches would only be affected if defaults reached a high enough level to wipe out the equity and the mezzanine investors. (This arrangement has been compared to a set of buckets, where money that is being repaid on the loans flows in like water, filling the top bucket first—that is, the “senior” tranche—then flowing down to fill the next bucket, and so on down the line. The bottom bucket—representing the “equity” tranche—gets filled only after all the others have been).

This structure is what made it possible to convert a batch of rather poorly rated loans into AAA-rated securities. If one were to take a single subprime loan, the chances of repayment would be rather difficult to determine. But if one were to pool a thousand such loans, with sufficient diversification, the chances that more than a certain percentage of them would default would actually be quite low. And so, if one were to purchase the right to collect from the best-performing loans in the pool, then that might well merit an AAA rating, even if not one of the loans, taken singly, would merit that rating. In this way, the MBSs (or CDOs) were essentially providing a type of insurance to “senior” investors against suffering losses from default. This was often castigated as an attempt to “spin straw into gold,” a suggestion that ignores the fact that real economic value was being produced through this risk-pooling arrangement.

Finally, there were credit default swaps (CDSs), which were the closest thing to a conventional insurance contract (and many were sold by an insurance company, AIG). In the simplest case, these could be purchased to “insure” a loan, so that in the event of default by the borrower, the owner of the CDS would receive a payment (typically the face value of the loan). They could also be purchased as protection against a variety of other “credit events,” such as the default of bond, such as a CDO, or a downgrade of its rating. Despite some superficial differences, CDSs were essentially insurance arrangements. Of course, if one were to sell only a single CDS, then one would be assuming the full risk associated with a credit instrument. But if one were

11. To take just one example, George Akerlof and Robert Shiller describe complex securities in the following terms: “Relying on curious financial alchemy, investors combined these products in clever ways, thinking that they were thus able to exercise the underlying risk.” Animal Spirits (Princeton, NJ: Princeton University Press, 2009), 87. This makes it sound as though there was some kind of hucksterism involved in the design of these instruments. And while there was no doubt a great deal of hucksterism involved in their sale, I would resist the suggestion that the essential design was flawed.
to sell hundreds or thousands of CDSs, then one could predict with a high degree of confidence how much to set aside to cover losses (as well as make use of various natural hedging strategies that would present themselves, in the course of writing such a large portfolio).

In retrospect, it is easy to see that all three of these insurance systems were poorly designed and regulated, resulting in significant moral hazard problems. In particular, it is important to recognize the very basic error in the regulatory structure governing CDSs that permitted the construction of the “tower of finance,” whose collapse was really the central event that transformed a downturn in the US property market into a global banking panic and credit crisis. But there was also a general disregard for correlation risk. Where this showed up in particular was in the rather casual concern for correlation risk in the recursive application of the basic securitization formula. While the banks had a relatively easy time finding investors willing to purchase the most senior tranches, as well as the equity tranches (because of their high rate of return), they often found themselves unable to sell the mezzanine tranches. Strictly speaking, the CDO arose when someone had the idea of taking the unsold mezzanine tranches of a set of MBSs, then combining these into a new security, the CDO, which would again be tranched into equity, mezzanine, and senior debt. In this way, a significant fraction of the mezzanine debt could be re-classified and sold as AAA. And again, the unsold mezzanine tranches of these CDOs could be recombined, producing a CDO squared, and so on. This procedure is sometimes discussed as though it were inherently fraudulent, which it is not—the basic principle is sound. The problem is that the diversification achieved by combining tranches of multiple CDOs into a new CDO was almost entirely illusory. In other words, the risks that were being pooled were not really independent of one another. Typically, the original CDO was already so well diversified that any event large enough to generate default rates of over 10 percent (say) in one CDO would have to be fairly momentous, and so would probably cause similar default rates in all other CDOs as well. Thus, pooling together the mezzanine tranches of multiple CDOs did not really offer any additional protection against default, because the underlying risk of default in the instruments was already highly correlated. This was a huge design flaw in the implicit insurance system in these securities, particularly in the “higher-order” CDOs.

The situation was not much better with the CDSs. The most consequential decision here was obviously the decision not to classify these products as insurance, for regulatory purposes, leaving AIG and others free to set aside as little money as they liked to cover claims. The more specific problem, however, arose from the fact that individuals were free to take out insurance against default on loans when they themselves were not the lender (so-called naked CDSs). Like life insurance in the early nineteenth century, completely uninvolved third parties were left essentially free to speculate on the outcome

12. For discussion, see Bethany McLean and Joe Nocera, All the Devils Are Here (New York: Penguin, 2011), 283–84.
of other people’s fortunes. This in itself would not have been so problematic, except that it provided the second foundation stone for the “tower of finance” that was erected. Purchasing CDSs on other people’s CDO holdings became a way of shorting the market for mortgage-backed securities. But this in turn led to the development of synthetic CDOs. By securitizing the right to collect premium payments on the CDSs, financial institutions were able to create an asset whose value would exactly track the value of the CDOs on which the CDSs were written, even though it would involve no claim on the underlying assets. The sale of these synthetic products expanded dramatically in the three years leading up to the crisis, eventually becoming more popular than the actual CDOs. And if CDSs were being written on these synthetic CDOs, they could in turn be bundled up and resold as a new batch of synthetic CDOs—a process that in principle could go on forever. All of this vastly increased correlation risk—creating a situation where “credit events,” such as defaults on a bond payment, were less likely to be independent of one another—something that a well-designed insurance system should have been alert to, and have taken measures to control.

So while the headline events of the financial crisis were a set of classic bank runs, first against Bear Stearns and then against Lehman Brothers, what was perhaps more shocking to observers was the sudden and dramatic loss of value across the world of so many of the securities that had been being traded. It is not just that the market for them became illiquid. It is that some of their economic value disappeared. The reason for this is not so difficult to understand, if one recognizes that part of their value came from their insurance-like characteristics. People who bought senior tranches of a CDO were not just buying the rights to collect from a batch of loans, they were also, implicitly, purchasing a certain form of insurance against default risk. When those risks became correlated, the insurance portion of the CDO simply lost its value. According to one estimate, the AAA tranches of CDOs lost around 20 percent of their value, even before they began to suffer actual defaults. This in turn triggered CDSs, which in turn undermined the value of synthetic CDOs, leading to a collapse of the tower.

5. CATALLACTIC BIAS

It is by now well understand that the financial crisis involved a very complex combination of perverse incentives and bad behavior on the part of homebuyers, mortgage originators, investment banks, ratings agencies, and government-sponsored enterprises. In retrospect, however, one of the most striking features of the events leading up to the crisis was the passivity of regulators in the face of growing threats, and in particular, in the face of the explosive growth

13. See Lewis, *The Big Short*.
in the creation and sale of derivatives. Part of this had to do, I would sug-
gest, with the conviction that trading risks necessarily increased financial sta-
Bility, because it involved a transfer of those risks to those better able to
bear them. This would only be the case, however, if one thought of insurance
on the model of a gain from trade and not as a risk-pooling arrangement.
A recent handbook on the subject described correlation risk as “a relatively
overlooked type of risk until it caused major unexpected losses during the
financial crisis of 2007 through 2009.”

Although the ratings agencies did explicitly factor in correlation risk when rating securities, they could be accused of having been somewhat lackadaisical about it.

With regulators, however, the omission was more complete. One can
gain some insight into their thinking by considering Greenspan’s comments,
in his fabulously ill-timed 2007 book The Age of Turbulence. His basic frame-
work for understanding globalization was in terms of an increase in the divi-
sion of labor and the specialization that this facilitated. The growth of financial
products was, in his view, part of this increased specialization. Thus, he wrote
that “with the advent of the ability to do around-the-clock business real-time
in today's linked worldwide markets, derivatives, collateralized debt obliga-
tions, and other complex products have arisen that can distribute risk across
financial products, geography and time.” Similarly, he described the rising
debt load of US households as “largely a reflection of dispersion of a grow-
ing financial imbalance of economic entities that in turn reflects the irreversible
up-drift in division of labor and specialization.”

His constant references to Adam Smith, on the one hand, merely reflect
his conviction that there is an “international invisible hand” that governs
the response to financial shocks, but on the other hand suggests that his
analysis of the market was still governed by the model of a division of labor.
Thus, when he talks about the “spreading,” the “dispersion,” or the “distribu-
tion” of risk, his formulations all suggest that he was thinking about it in
terms of exchange relations and gains from trade. Some of his earlier speeches
made this more explicit.

The development of our paradigms for containing risk has emphasized,
and will, of necessity, continue to emphasize dispersion of risk to those
willing, and presumably able, to bear it. If risk is properly dispersed,
shocks to the overall economic system will be better absorbed and less
likely to create cascading failures that could threaten financial stability.
A major contributor to the dispersion of risk in recent decades has
been the wide-ranging development of markets in securitized bank loans,

18. Greenspan, Age of Turbulence, 359.
credit card receivables, and commercial and residential mortgages. These markets have tailored the risks associated with holding such assets to fit the preferences of a broader spectrum of investors.\textsuperscript{20}

There are two key phrases here. The first is the claim that, through increased trade in derivatives, risks were being allocated to those most able to bear them. The second is the suggestion that risks are being tailored to suit the preference of investors. (Ben Bernanke used similar language, in 2006, when lauding the fact that “the development of new technologies for buying and selling risks has allowed many banks to move away from the traditional book-and-hold lending practice in favor of a more active strategy that seeks the best mix of assets in light of the prevailing credit environment, market conditions, and business opportunities”\textsuperscript{21}). These phrases all suggest an assimilation to the “gains from trade” model—as though insurance contracts represented, first and foremost, an exchange between a risk-averse and a risk-neutral agent. If this were the case, then each transaction would necessarily enhance the stability of the system, because it would take any losses and redirect them to the parties best able to bear them. Furthermore, if one thinks of risk aversion in terms of relative wealth, then it seems natural as well to think of the more risk-neutral party as simply the wealthier one, and hence as the one least at risk of default in the face of a particular loss. As a result, if one contemplates the increased volume of transactions, and one thinks of each one as involving the “trading” of a risk, then it is practically axiomatic that each single transaction will increase the overall stability and resilience of the financial system.

But if instead one sees many of these transactions as involving the “pooling” of a risk, then a dramatic increase in volume may look rather more worrisome. Because of correlation risk, some fraction of the value of these securities and derivatives is at risk of disappearing. A common thread throughout much of the commentary preceding the financial crisis, among those who were seeking to minimize the impact of worsening conditions in the US housing market, was to emphasize how unlikely it was that defaults would actually reach the senior tranches of the CDOs. What these commentators failed to anticipate was that the senior tranches would begin to suffer “paper” losses even without suffering any “cash” losses, thanks to the dissolution of the risk protection afforded by the lower tranches.\textsuperscript{22} This resulted in downgrades of the formerly AAA-rated bonds, which forced many institutional investors to


\textsuperscript{22} Das, Extreme Money, 203.
sell, and also triggered CDS payments, which in turn imposed losses on synthetic CDOs. Because all of these securities were purchased and exchanged by highly leveraged financial institutions, this was sufficient to set off a cascading sequence of losses.

6. CONCLUSION

Satyajit Das summed up the attitude that many people have toward CDOs when he wrote that “CDO logic is perverse. It’s a bank. You buy loans and other credit risk from the market, then you cut it and dice it and sell it to investors. Assume you buy all the tranches—equity, mezzanine, and senior. In effect, you just own the loans; you should earn exactly the market price of the loan; it should be impossible to make money. Certainly, it should be impossible to make the profits made by credit derivative desks.” 23 This was written in 2006, before the sudden collapse in value of these instruments. In retrospect, Das came out looking like a sage—especially when compared to, say, Greenspan.

As a former trader, and the author of several textbooks on derivatives, Das cannot be accused of not understanding the products that he is criticizing. And yet, perhaps as a consequence of overexposure to the hucksterism involved in the sale of these products, he has a tendency to adopt an overly cynical view toward them. The entire concept of “risk management” is, in his view, something of a misnomer, since the risk never goes away, it just gets pushed around, like a bump under the carpet. Thus, he articulates what he calls “the principle of risk conservation,” which is that “the amount of risk is constant, it cannot be reduced, it just gets passed around between the players.” 24 The central difference between him and Greenspan is that he is more inclined to view this “passing around” on the model of a game like “hot potato,” or “old maid,” than on the model of a gain from trade. (“The trick for traders generally is to avoid holding the risk and therefore ending up miserable,” he writes.24).

Thus, his verdict: “Much of the financial innovation was designed to conceal risk or leverage, obfuscate investors, and reduce transparency. Complexity was used to make products difficult to understand and analyze, allowing them to be priced inefficiently to produce excessive profits for traders.” 25 Again, there can be no doubt that this was in many instances true. And yet the thought that there was nothing more to it than this strains credulity. There was, I have tried to suggest, a sound idea at the heart of these securities. While the underlying risk remains unchanged, it is nevertheless possible to create economic value by minimizing the negative effects on human welfare that this risk imposes. The problem is that the limitations of the mechanism of cooperative benefit through which this minimization is achieved, as well as the peculiar risks that its use creates, were not well enough understood.

25. Das, Extreme Money, 255.

SEUMAS MILLER

1. INTRODUCTION

It is uniformly agreed that the Global Financial Crisis (GFC) and its aftershock, the so-called Sovereign Debt Crisis (SDC), constitute the greatest global economic calamity since the Great Depression. The main aspects of the problem have included frozen credit markets, the subprime mortgage crisis, slow and inconsistent policy responses, escalating sovereign debt, and an unfolding global (or near global) recession. The crisis has involved major corporate investment and mortgage banking collapses and bailouts in the United States (Lehmans, Freddie Mac and Fannie Mae), United Kingdom (Northern Rock), and Europe (Fortis, Hypo) and has had a devastating effect on homeowners who cannot pay their mortgages (foreclosures), retirees whose pension funds have plummeted in value, employees whose jobs have been lost or are at risk in the recession, and taxpayers whose money is being injected into the banking system in vast quantities to rescue it (e.g., trillions of dollars by the US government).

Unethical, including imprudent, practices have been identified as being among the principal causes of the crisis. These practices include (1) reckless and predatory lending by banks; (2) developing highly leveraged investment banks; (3) the selling of toxic financial products, notably nontransparent...
packaged bundles of mortgages (including subprime mortgages) assessed by ratings agencies as high quality because the investment banks that packaged them had good risk assessment processes, securitized, and sold by banks to pension funds; (4) massive frauds, for example, Bernie Madoff’s ponzi scheme; (5) allowing the growth of unsustainable debt by governments and, indeed, whole economies, for example, the US overseas debt accumulated in 2006 alone was $850 billion; (6) excessively loose monetary policy by central banks; (7) the negligence and/or complicity of legislators and regulators regarding all of the above.

Moreover, while the crisis has evidently eased, the bad news regarding unethical behavior, and accompanying financial risk on the part of global banks, continues. There have been a rash of post-GFC money-laundering scandals (e.g., HSBC), incidents of banks facilitating tax evasion through offshore accounts (e.g., UBS), and rogue traders who have continued to wreak havoc (e.g., the so-called London Whale at JP Morgan Chase).

However, the most important unfolding corruption scandal, or sequence of scandals, in the international banking sector at the time of writing is undoubtedly the manipulation of financial benchmarks. To date, the most prominent of these is the Libor (London interbank offered rate) scandal. Libor is a globally important benchmark calculated for ten major currencies, administered by the British Bankers’ Association (BBA) and published daily; it has been subject to manipulation by many, if not most, of the leading global banks.1 Moreover, libor manipulation turns out to be just one among an array of financial benchmarks which have been subject to manipulation. Others include euribor (euro interbank offered rate) and tibor (Tokyo interbank offered rate). Indeed, the European Union’s investigation into manipulation of financial benchmarks has led to fines for six global banks—JP Morgan Chase, Citigroup, Société Générale, UBS, Royal Bank of Scotland (RBS), and Barclays. With fines totaling $2.3 billion, this is “the largest cartel fine in history.” 2 As if this wasn’t enough, it now seems that it is not simply interbank interest rate benchmarks that have been manipulated but, very probably, foreign currency exchange rate (forex) benchmarks, notably, WM/Reuters reference rates.3

Accordingly, the question arises as to where it will all end; indeed, some commentators are already suggesting that we are or have been on the cusp of one of the greatest corruption scandals in international banking history.4

In this context, I note that these and other financial benchmarks and indexes constitute financial infrastructure and, as such, have a key role in a


multitude of financial transactions worth trillions of dollars.\textsuperscript{5} While prices, including interest rates and currency exchange rates, obviously depend on supply and demand, it turns out that they also depend on reference rates (financial benchmarks) set by (ideally, but not necessarily in fact) independent administrators on the basis of (again ideally, but not necessarily in fact) objective transactional data. In short, decision making by market actors in financial markets relies crucially on financial benchmarks.

Significantly, the various manipulations of financial benchmarks in question have involved collusion between banks and have implicated senior bank staff; so the matter cannot simply be dismissed as a case of “a few rotten apples.” As I argue below, the fact that there is widespread collusion within and between banks implies that there is collective responsibility both for the malfeasance itself and for the failure to prevent it.

At the very least, it is evident that post-GFC global banks have not mended their unethical ways. Moreover, it seems that large-scale corporate collapses and corruption scandals in the global financial sector in general, and the global banking sector in particular, are a recurring phenomenon.\textsuperscript{6}

Given that this recurring phenomenon is massively harmful in its economic and social impact on mortgage holders, shareholders, investors, employees, retirees, and so on it goes without saying that there is a need to address it. Moreover, it would appear that what is called for is a holistic approach which not only focuses on micro-institutional mechanisms, such as the workings of particular financial benchmarks, but also on some of the macro-institutional aspects of the banking sector that might bear on this and related ethical problems.

Central among these macro-institutional aspects is surely the phenomenon of global financial institutions that are “too big to fail.”\textsuperscript{7} Thus, there were a number of bailouts of major banks and other financial institutions following the decision in 2008 to allow Lehman Brothers to fail; a decision which is thought to have virtually brought the international financial system to its knees. Importantly for our concerns here, the phenomenon of banks that are “too big to fail” has morphed into the phenomenon of banks that are “too big to manage” and, indeed, “too big to jail” or, less colloquially, “too big to regulate.” For example, there is the recent case of the multinational bank HSBC, and international money-laundering activities of criminal

\textsuperscript{5} For details, see Gabriel Rauterberg and Andrew Verstein, “Index Theory: The Law, Promise and Failure of Financial Indices,” \textit{Yale Journal on Regulation} 30, no. 1 (2013): Article 2. <http://digitalcommons.law.yale.edu/yjreg/vol30/iss1/2>


\textsuperscript{7} See, for example, U.S. Attorney-General Eric Holder’s answers to the Senate Judiciary Committee as reported in Andrew Ross Sorkin “Realities Behind Prosecuting Big Banks,” \textit{New York Times} (March 12 2013), B1.
organizations, such as Mexican-based drug cartels.\(^8\) The latter were found to have used HSBC for this purpose over a ten-year period resulting in a US $1.9 billion fine for HSBC for failing to have in place effective anti-money-laundering measures and for failing to conduct due diligence on some of its account holders. Criminal negligence notwithstanding, HSBC retained its license to operate having in effect been deemed by the regulators “too big to fail.” However, the inference that is being drawn from HSBC’s retention of its license in these circumstances is that it is, in effect, too big to regulate.

The general proposition that the banks are beyond the reach of regulators, whether because they are too big to regulate and/or for other reasons (e.g., regulatory capture), is further evidenced by the paucity of criminal convictions of senior bank personnel in this context of widespread and ongoing malfeasance in the global banking sector. For example, evidently the US Department of Justice (USDJ) has yet to prosecute successfully any bank personnel at the most senior levels for criminal behavior during and in the aftermath of the GFC. It simply beggars belief that senior Wall Street executives, including CEOs and board members, have not personally been engaged in various forms of criminal behavior, such as fraud or, at the very least, criminal negligence.

In addition to structural and associated regulatory reform, at micro and macro levels, there is a need to address issues of culture, though these are closely related. For example, there is a culture within the sector, or large parts of it, which is conducive to interest-rate rigging and, for that matter, other unethical practices. If so, structural and associated regulatory redesign needs to go hand in glove with the reformation of banking culture. Such reformation may well involve a process of professionalization, or at least of occupational ethical acculturation.

I take it that a fundamental problem that needs to be addressed in relation to the above-described ongoing cycle of banking scandals is institutional corruption and that a currently important aspect of this institutional corruption is the manipulation of financial benchmarks. At any rate, this is my focus in this article. Moreover, as I have also argued elsewhere, a principal remedy for institutional corruption consists in institutionally embedding collective moral responsibility. Accordingly, in this article, my task is threefold: (1) to provide an appropriate theoretical normative analysis of the kinds of key global financial benchmarks in question, namely, libor and WM/Reuters reference rates; I will do so in terms of my notion of a joint institutional mechanism\(^9\); (2) to establish and defend an appropriate theoretical notion of

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collective moral responsibility; here I rely on my notion developed elsewhere in detail of collective moral responsibility as joint moral responsibility\(^{10}\); (3) to explore the ways in which collective moral responsibility can be institutionally embedded in the service of substantially reducing the actual and potential corruption of financial benchmarks.

2. FINANCIAL BENCHMARKS

2.1 The Manipulation of Financial Benchmarks: Libor and WM/Reuters Reference Rates

The libor is the average short-term (e.g., daily [shortest term], yearly [longest term]\(^{11}\)) interest rate that leading international banks estimate they would have to pay if borrowing from other banks. The most important libor is the three-month interest rate for US dollars. The average interest rate calculations are based on submissions to the BBA by the leading banks in question; these submissions ought to be the bona fide estimations by the leading banks of the interest rates they would have to pay. I note that these estimations not being calculations derived from actual observed transactions are inherently subjective and, as such, lend themselves to “falsification.”

Libor is used as an interest rate benchmark by many financial institutions, mortgage lenders, and credit card agencies, that is, they use libor as the reference point for setting their own interest rates. According to Martin Wheatley (of the Wheatley Review of Libor\(^{12}\)), “Libor is used in a vast number of financial transactions, with a value of at least $300 trillion.”\(^{13}\) Indeed, according to The Economist, Libor is the most important figure in finance.\(^{14}\)

The libor scandal involves the rigging of libor (either by pushing rates up or pushing them down). The leading banks in question rigged libor by means of fraudulent and collusive submissions to the BBA. For example, at the height of the GFC, Barclays’ management caused their staff to falsify the bank’s libor submissions; on numerous occasions the interest rate submitted was lower than the actual estimation of the interest rate at which the bank could borrow in order to give the appearance that the bank was in


11. There are actually fifteen such borrowing periods or tenors.


better financial health than was in fact the case.\textsuperscript{15} In addition, their bank traders made huge profits for the bank (and increased bonuses for themselves) manipulating libor. They did so by causing their colleagues making the libor submissions to adjust those interest rate submissions (upwards or downwards). Even very small changes in libor enable traders to make huge profits if they can predict those changes in advance. On occasion libor manipulation involved interbank collusion; the UK Financial Services Authority (FSA) found this to be the case in its investigation of libor manipulation in the RBS.\textsuperscript{16}

As mentioned above, investigations by the FSA, the USDJ, and other regulatory authorities have resulted in massive fines being imposed on major banks such as Barclays, UBS, and the RBS. For example, UBS has been fined $1.5 billion.\textsuperscript{17} In addition, again as mentioned above, massive fines have been imposed on six global banks for financial benchmark manipulation by EU authorities. Clearly, the problem is systemic.

In addition to the institutional and reputational damage and the massive fines, there is the matter of (actual and potential) lawsuits filed on behalf of those who have been adversely affected by the manipulation of libor, for example, investors who earned a lower rate of interest than otherwise would have been the case, and mortgage holders whose interest payments were higher than otherwise would have been the case. The financial impact of these lawsuits (including class actions) may ultimately dwarf the fines being imposed on banks by the regulators.

What of the emerging corruption scandal of foreign currency exchange rate benchmark manipulation? According to a Bloomberg report citing five dealers, a number of the world global banks manipulated benchmark foreign exchange rates, specifically market leader WM/Reuters rates.\textsuperscript{3} Such rates are used as benchmarks in the $5 trillion a day foreign exchange markets.

According to Bloomberg:

WM/Reuters rates are published hourly for 160 currencies and half-hourly for the 21 most-traded. They are the median of all trades in a minute-long period starting 30 seconds before the beginning of each half-hour. Rates for less-widely traded currencies are based on quotes during a 2-minute window.\textsuperscript{18}


The WM/Reuters rates are used by fund managers to compute the day-to-day value of their holdings and by index providers such as FTSE Group and MSCI Inc. that track stocks and bonds in multiple countries. While the rates are not followed by most investors, even small movements can affect the value of what Morningstar Inc. estimates is $3.6 trillion in funds including pension and savings accounts that track global indexes.  

Thus, manipulation of WM/Reuters rates can influence the returns earned by investors, including retirees accessing pension and savings funds and shareholders. Consumers are also potential losers. According to John Coffee, a securities law professor at Columbia University, “Any corporation with global operations has to hedge currencies using futures and swaps. If the FX market is manipulated, it can create a loss that is passed on to the consumer and shareholders.”

Manipulation of benchmark foreign exchange rates has been investigated by various regulatory authorities, such as the UK Financial Conduct Authority and the US Securities and Exchange Commission and Commodity Futures Trading Commission. Banks implicated in this emerging corruption scandal include Barclays, UBS, Citigroup, Deutsche Bank, RBS, and JP Morgan—all of whom have suspended traders pending internal or external investigations.

According to *Frontline*,

Four banks—Deutsche Bank, Citigroup, Barclays, and UBS—account for more than 50% of the market. The euro-dollar currency pair is the most liquid, and that portion of the market accounts for a quarter of all spot transactions. And fewer than 100 traders run the spot market. This structure provides the base for collusion among traders.

In the context of the above WM/Reuters rates manipulation allegations, the already proven collusion-dependent corruption of libor, euribor, and so on, regulators’ concerns in relation to anomalous movements in exchange rates,
and in some key foreign exchange markets which are highly concentrated, there is a strong suspicion of collusion-dependent corruption in relation to manipulation of foreign exchange rates. Evidently, we have yet another instance, or set of instances, of collective moral responsibility for both financial benchmark corruption and failure to prevent it.

2.2 Financial Benchmarks and Joint Institutional Mechanisms

An important subelement of most, if not all, institutions is what I have referred to elsewhere as a joint institutional mechanism.\textsuperscript{26} Benchmarks such as libor and WM/Reuters reference rates are, I suggest, examples of such mechanisms. Other examples are tossing a coin to resolve a dispute and voting to elect a candidate to political office.

Joint institutional mechanisms\textsuperscript{27} consist of (1) a complex of differentiated but interlocking actions (the input to the mechanism); (2) the result of the performance of those actions (the output of the mechanism); and (3) the mechanism itself. In the case of libor, the inputs are the interest rate estimates submitted by the banks. In the case of WM/Reuters reference rates, it is the actual observed transactional data (e.g., all the trades in the minute-long period [see above]). So there is interlocking and differentiated action (the various inputs of the submitters). Further, there is the process applied to the inputs (the mechanism). In the case of libor, this mechanism consists of averaging the various submissions,\textsuperscript{28} and in the case of WM/Reuters reference rates it consists of calculating the median of the observed trades during some hour or half-hour period. The application of the mechanism (the averaging process or calculation of median process) to the input (the submissions or trades) yields an output, namely, the libor interest rate for some currency over some period or the reference rate for exchange of some currency with another currency over some hourly or half-hourly period.

Note the following important points regarding these joint institutional mechanisms, assuming they are working as they should and realizing their normative institutional purposes, that is, if they are not malfunctioning or corrupted. First, in each case, there is a result is (in part) constitutive of the mechanism. The result (i.e., the resulting interest rate or foreign exchange reference rate) is not aimed at by each or any of the economic actors providing the data; after all, none of these actors can predict the result, let alone bring it about by aiming at it. (I am assuming the mechanism in question is uncorrupted and not malfunctioning.) Nevertheless, in the case of libor, each of the participants in the mechanism (e.g., the bank submitters) has a common end (more precisely,

\textsuperscript{26} Miller, Moral Foundations of Social Institutions, 50–52.

\textsuperscript{27} Miller, Social Action; Miller, Moral Foundations of Social Institutions.

\textsuperscript{28} The averaging process is somewhat more complex than simple averaging since some of the highest and lowest submitted rates are excluded from it. However, this is a sufficient description for our purposes here.
a collective *epistemic* end—see Section 3^{29}); namely, that the average interest rate—whatever that is—will be produced by this mechanism. Similarly in the case of the foreign exchange reference rates, the parties to the mechanism have a common end, namely that the median foreign exchange rate—whatever that is—will be produced by the mechanism. Note that in the case of foreign exchange transactions the traders whose trades are being observed are participants in the mechanism by virtue of their being willing,^{30} presumably qua market participants committed to the relevant benchmark, to make the details of their transactions known to WM/Reuters for the purposes of enabling the personnel at the latter to generate the reference rates in question.

Second, the generation of an interest rate or exchange rate reference rate by such a mechanism serves a further institutional purpose which is the raison d’être of the mechanism (and, as such, in part constitutive of it), namely that of providing a *benchmark* (interest rate or foreign exchange reference rate) upon which various institutions and individuals can rely. So at one level of description, the result of the application of the mechanism is simply a particular interest rate arrived at by averaging or a particular exchange rate arrived at by calculating the median, that is, they are just *numbers*; but at another level of description, these rates are *benchmarks*. This ultimate benchmarking purpose is itself a collective end of the joint institutional mechanism, but one aimed at not just by the bankers (in the case of libor, the submitters and the compilers of the rates) or the traders (who provide the transactional data) and the personnel at WM/Reuters (in the case of the foreign exchange reference rates) but also by those who use libor to set their own interest rates or use the foreign exchange reference rates to conduct their own foreign exchange transactions or related financial activity. That any one of the two kinds of rates in question serves as a benchmark is an end which is realized not simply by the banks generating it via their submissions, or the personnel at WM/Reuters via the trades they observe, but also by other institutions and individuals using it as such. Absent the participation of both parties (or categories of party), the financial benchmarks of libor and WM/Reuters foreign exchange reference rates would have no point and would cease to exist.

Third, the benchmarking purpose or collective end of joint institutional mechanisms, such as libor and WM/Reuters’ reference rates, is what I have elsewhere referred to as a collective good.^{31} Accordingly, it is something that *ought to be* jointly aimed at by relevant participants; it ought to be aimed at (other things being equal) because it is a good (albeit, in the case of benchmarks, an instrumental good). In short, financial benchmarks are not

^{29} More precisely, there is a two-stage process, the first stage of which is the production of Libor, the second stage of which is its communication and acceptance by numerous institutions and individuals as a credible benchmark. The collective end is an epistemic one since it consists in an item of knowledge (ideally). For more on this, see Miller, *Moral Foundations of Social Institutions*, Chapter 11.

^{30} Or at least their superiors are willing to allow these trades to be observed.

simply prices consequent upon supply and demand but which no one is actually aiming at; rather they are the aimed-at average or median (or other numerical relationship) calculated on the basis of recorded transactional data or judgments thereof. Moreover, they are calculated, promulgated, and relied upon as a collective good, that is, as a mutually known benchmark upon which market actors can rely. Accordingly, they constitute, I suggest, financial infrastructure underpinning market activity in the finance sector.

Fourth, and needless to say, providing false submissions, or otherwise seeking to manipulate the results of the mechanism, is a matter of breaching one’s moral obligations, given its important institutional purpose (it is a collective good) and the consequent trust placed in it by so many. This point has been reinforced by the recommendation of the Wheatley Review and the Monetary Authority of Singapore, that noncompliance with the requirements of libor, for example, by intentionally making false submissions, be a criminal offense.

From an analytical moral perspective, a dual feature of the manipulation of benchmarks, a feature which might go some way to explaining their prevalence, is that, on one hand, manipulation can yield huge financial rewards for those who engage in it, and on the other, the harms caused to victims can be thought to be spread very thinly—millions of individuals get cheated, but only out of a relatively small amount, so that no one is seriously harmed. This may well be largely true if only a single act of manipulation is considered, though even here there are important exceptions. For example, a retiree’s single large savings investment with an overseas component may be substantially adversely impacted by foreign exchange rate manipulation on the date of the investment’s maturity. In the case of multiple acts of manipulation over time, it is much less likely to be true that the harms caused are spread thinly. For example, an individual could suffer great financial harm if inflated interest payments on a house or reduced investment returns to a retirement fund are aggregated over decades. There is also the matter of the institutional, including reputational, damage resulting from the undermining of trust in the benchmarks in question once they are known, or even falsely believed, to be manipulated.

One important difference between libor and WM/Reuters reference rates is that the latter are more directly based on observed transactions—as opposed to subjective judgments about what the rate would be. A second important difference is that the administrator operating the mechanism and those supplying the transactional data are not the banks or bank personnel themselves (via their representative body, BBA); so there is not the same structural conflict of interest and potential for collusion between submitters—or in the case of WM/Reuters observers of the transactions—and traders as in the case of libor. In these two respects, libor is surely in need of reform. On the other hand, most foreign currency transactions take place outside organized

exchanges and are subject to even less regulation than interest rate benchmarks such as libor. In this respect, foreign exchange rate benchmarks are surely in need of reform.

3. COLLECTIVE MORAL RESPONSIBILITY

Collective moral responsibility is a species of moral responsibility. Here, we need to distinguish moral responsibility (including collective moral responsibility) from causal responsibility.33 A person or persons can inadvertently cause a bad outcome without necessarily being morally responsible for so doing. Moral responsibility typically requires not only causal responsibility but also an intention to cause harm or the knowledge that one’s action will or may well cause harm, whether harm to persons or institutions or (more likely in the kinds of cases under consideration here) to both.

We also need to distinguish moral responsibility for actions and moral responsibility for omissions and retrospective from prospective moral responsibility. All these distinctions in respect of individual moral responsibility are mirrored in the case of collective moral responsibility. Hence, the various different but related questions that arise: Who are collectively morally responsible for the corruption of a financial benchmark by their acts or omissions? Who are collectively morally responsible for ensuring it does not recur? In this article, my primary concern is with the latter question and this is the focus of the final section in particular.

Collective moral responsibility is the moral responsibility that attaches to structured and unstructured groups for their morally significant actions and omissions. Thus, an organized gang of thieves who carry out a million dollar bank heist or a gang of bank employees who carry out a multimillion dollar interest-rigging fraud is said to be collectively morally (and, one might have expected, legally) responsible for the theft and fraud (respectively) and also for the resulting harm to those affected, for example, depositors or investors.

Elsewhere, I have elaborated and defended a relational account of collective moral responsibility; specifically, that of collective responsibility as joint responsibility.34 On this view, collective responsibility is responsibility arising from joint actions and omissions.

Roughly speaking, a joint action35 can be understood thus: two or more individuals perform a joint action if each of them intentionally performs an individual action (or omission), but does so with the (true) belief that in so doing, they will jointly realize an end which each of them has.

33. And also from notions of accountability and liability. See Andre Nollkaemper and Dov Jacobs, Shared Responsibility in International Law: A Conceptual Framework, Amsterdam Law School Research Paper No. 2011-17 (Amsterdam: Amsterdam Center for International Law, 2011) for discussions of these notions in international legal contexts.


So joint actions are interdependent actions directed toward a common goal or end. But what is such an end? This notion of a common goal or, as I shall refer to it, a collective end, is a construction out of the prior notion of an individual end. Roughly speaking, a collective end is an individual end more than one agent has, and which is such that, if it is realized, it is realized by all, or most, of the actions of the agents involved; the individual action of any given agent is only part of the means by which the end is realized. Realizing the collective end is bringing into existence a state of affairs. Each agent has this state of affairs as an individual end. (It is also a state of affairs aimed at under more or less the same description by each agent.) So a collective end is a species of individual end.36

On this view of collective responsibility as joint responsibility, collective responsibility is ascribed to individual human beings only, albeit jointly.37 Each member of the group is individually morally responsible for their contributory action and also for the outcome of the set of actions. However, each is individually responsible for that outcome jointly with the others; hence, the conception is relational in character. Thus, in our million dollar bank heist example, each member of the gang is responsible jointly with the others for the theft of the million dollars because each performed his contributory action in the service of that collective end (the theft of the million dollars).

The key notion of joint action underpinning collective responsibility can be construed very narrowly or more broadly. On the most narrow construal we have what I will call basic joint action. Basic joint action involves two co-present agents each of whom performs one basic individual action, and does so simultaneously with the other agent, and in relation to a collective end that is to be realized within the temporal and spatial horizons of the immediate face-to-face experience of the agents. A basic individual action is an action an agent can do at will without recourse to instruments other than his or her own body. An example of a basic individual action is putting one’s hand in the till and seizing a wad of banknotes; an example of a basic joint action is two people lifting a safe onto the back of a truck.

If we construe joint action more broadly, we can identify a myriad of other examples of joint action. Many of these involve the intentions and ends of multiple institutional actors directed to outcomes outside the temporal and/or spatial horizon of the immediate experience of those actors, for example, the members of a management team setting revenue targets and developing


37. Accordingly, there is no need to hold that collective responsibility attaches to collective entities per se, as collectivist theorists such as Margaret Gilbert and (in a somewhat different vein) Philip Pettit have done. For criticisms of these collectivist accounts, see Seumas Miller and Pekka Makela, “The Collectivist Approach to Collective Moral Responsibility,” Metaphilosophy 36, no. 5 (2005): 634–51.
strategies in the context of a plan to grow their business over a five-year period.  

We can further distinguish between two species of joint action, namely joint behavioral action and joint epistemic action. Unlike joint behavioral action, joint epistemic action is directed to (collective) epistemic ends, notably knowledge—for example, members of a team of accountants seeking knowledge of the assets and liabilities of a company. As is the case with joint behavioral actions, participants in joint epistemic actions are collectively (jointly) morally responsible for morally significant joint epistemic actions—for example, the members of a team of auditors from Arthur Anderson who conducted an unsuccessful audit by virtue of failing to unearth fraudulent “special purpose entities” at Enron.

Naturally, epistemic action can, and often does, involve behavioral action and vice versa. Consider, for example, the evidence-gathering activities of auditors sifting through documents, conducting interviews, and so on. However, I suggest that epistemic action does not necessarily involve behavioral action. For example, mental acts of judgment are epistemic actions because directed at truth, knowledge, understanding, or some other epistemic end; but they are not necessarily instances of behavioral action.

Note that the collective ends of joint epistemic actions are importantly different from those involved in joint behavioral action. In the case of the former the content of the collective end (for example, the knowledge whether or not that p) is necessarily absent at the commencement of the joint epistemic action; for it is precisely that knowledge which the joint epistemic action is aiming to acquire.

In the section, I introduced a further species of joint action, namely joint institutional mechanisms. As we also saw above, financial benchmarks, such as libor and WM/Reuters reference rates, are joint institutional mechanisms. Joint institutional mechanisms play a central role in institutional activity, and it is important for my purposes in this paper that they can be understood in purely individualist terms by recourse to my core notion of joint action. For in that case the participants in morally significant joint mechanisms are, at least in principle, collectively (jointly) morally responsible for the input and output of these mechanisms.

On this account of joint institutional mechanisms, the various relevant bank submitters, traders, and/or managers involved in some particular episode of libor interest-rigging can be ascribed collective moral responsibility for this particular corrupt (joint) action and for any (personal and/or institutional) harm that might result from it. While each person is individually responsible for his or her contributory individual action or omission (e.g., a manager who signed off on a particular submission knowing it to be false), all those who

38. Miller, Moral Foundations of Social Institutions, Chapters 1 and 2.


40. I cannot pursue the complexities of this issue here, although I have done so elsewhere.
intentionally contributed to the joint action are collectively (i.e., jointly) mor-
ally responsible for the realization of its end (e.g., all those who colluded to
manipulate the interest rate in question so that they could profit from this).

Note that in most of the scandals, we are considering the network of
joint actions and omissions can be quite wide and complex without necessarily
involving all, or even most, personnel in a given institution. Moreover, some
joint actions or omissions might be of greater moral significance than others,
and some individual contributions, for example, those of senior bank manag-
ers, of greater importance than others.

Further, the cumulative damage done by an ongoing series of such epi-
sodes of corrupt action by numerous bank personnel from different institutions
and on multiple occasions might conceivably also be attributed to the entire
large group, though there are various barriers to the ascription of collective
moral responsibility in large groups in which each member only makes a
small causal contribution. In this connection, let us consider organizational
action and, specifically, layered structures of joint institutional action.

Institutions which are organizations consist of an (embodied) formal
structure of interlocking roles. An organizational role can be defined in
terms of the agent (whoever it is) who performs certain tasks, the tasks
themselves, procedures, and conventions. Moreover, unlike social groups,
organizations are individuated by the kind of activity that they undertake,
and also by their characteristic ends. Many organizations are also social insti-
tutions. Social institutions are organizations with a moral dimension by virtue
of, for example, the authority relations they involve and the fact that in many
cases their collective ends are also collective goods. Thus, governments have,
as a collective end, the regulation of other local institutions (a collective
good), universities the end of discovering knowledge (a collective good), and
so on.

Collective goods are not to be confused with public goods in the econo-
mists’ sense, that is, nonrival and nonexcludable goods, notwithstanding the
fact that financial benchmarks happen to be nonrival goods. Rather, collective
goods are goods that are jointly produced. For example, cars are typically
jointly produced; their production involves many different workers performing
a variety of different tasks. Moreover, collective goods in my sense are (either
necessarily or simply as a matter of contingent fact) enjoyed by multiple
actors; indeed, the members of the relevant community are entitled to access
to the good. Benchmarks are collective goods since they are a good which is

41. Miller, Social Action, Chapter 5; Miller, Moral Foundations of Social Institutions, Chapters
1 and 2.

42. Defined in detail elsewhere but, roughly speaking, the performance of a certain task in each
instance of a recurring situation.

43. Miller, Moral Foundations of Social Institutions, Chapter 2.

44. There are various complications arising at this point which I cannot pursue here, including
in relation to the property of excludability.
jointly produced, namely, by the actions (in the case of libor) of submitters, and the like; moreover, they are enjoyed by multiple economic actors and, indeed, economic actors in the relevant market are entitled to access to the good. 45

A further defining feature of organizations is that organizational action typically consists in what I have elsewhere termed a **multilayered structure of joint actions**. 41 One illustration of a layered structure of joint actions is a firm competing in a market-place. Suppose at an organizational level a number of joint actions (“actions”) are severally necessary 46 and jointly sufficient to achieve some collective end. Thus, the “management action” of the home loans management team in a bank in setting the interest rates of the bank’s home loans, the “compliance action” of the bank’s legal team in ensuring the loans and their associated lending processes are compliant with the relevant laws and regulations, and the “sales action” of the home loans sales team in the provision of home loans in accordance with sales targets might be severally necessary and jointly sufficient to achieve the collective end of maximizing the bank’s profits from home loans; these “actions” taken together constitute a joint action.

At the first level, there are individual actions directed to three distinct collective ends: the collective ends of (respectively) setting the interest rates, ensuring compliance, and meeting home loan targets. So at this level, there are three joint actions, namely the members of the management team setting interest rates, the members of the legal team ensuring compliance, and the members of the sales team meeting sales targets. However, taken together these three joint actions constitute a single joint action. The collective end of this second level joint action is to maximize revenue from home loans; and from the perspective of this second-level joint action, and its collective end, these (first-level joint) constitutive actions are (second-level) individual actions. I note that typically in organizations not just the nature but the quantum of the individual contributions made to the collective end will differ from one agent to another.

I have argued that collective moral responsibility is to be understood as joint moral responsibility: the joint moral responsibility of individual human actors engaged in morally significant joint actions (or omissions). I have further argued that the notion of joint action can be enriched so as to encompass action in accordance with joint institutional mechanisms (e.g., benchmarks such as libor) and organizational action, that is, multilayered structures of joint action. The upshot of this analysis is that individual human actors are,

45. Indeed, they have a joint right to the good. See Miller, Moral Foundations of Social Institutions, Chapter 2. Note that from the fact that one is entitled to access to a good it does not follow that one does not have to pay for it.

46. Here there is simplification for the sake of clarity. For what is said here is not strictly correct, at least in the case of many actions performed by members of organizations. Rather, typically some threshold set of actions is necessary to achieve the end; moreover, the boundaries of this set are vague.
at least in principle, collectively (jointly) morally responsible for morally significant organizational action.\footnote{This theoretical standpoint is not to be confused with the view that organizations and other collective entities can be reduced to the individual human organizational actors and their individual actions. The latter view is surely incorrect. Moreover, there are complexities here that I cannot pursue for reasons of space. I have discussed these complexities elsewhere.}

Accordingly, given that “the action” of (say) a bank in maximizing its revenue from home loans in a given period is to be understood as a multilayered structure of joint actions, and given this joint action is morally significant, then the various participants in it are collectively (jointly) morally responsible for its outcome. Here, it is important to note that within the set of individuals who are collectively morally responsible for some outcome, the degree of individual responsibility that some have (jointly with others) might be greater than the degree of individual responsibility that those others have; for example, managers will typically have a higher degree of individual responsibility than their subordinates. Moreover, if the contribution of some individuals is minute and they are only very indirectly connected to some morally significant outcome, then their degree of moral responsibility may well diminish to the point of nonexistence. And, of course, if some individual members of an organization did what they could to avoid participating in a multilayered joint action with an adverse outcome then these individuals may well not have any share in the collective moral responsibility for that outcome.\footnote{I have dealt with these questions in detail elsewhere.}

Further, in some cases of collective moral responsibility, no one is fully morally responsible for the adverse outcome; rather each has a share, so to speak, of the collective moral responsibility in question. The GFC is a case in point. No single individual (or, for that matter, organization) is fully morally responsible for the credit crisis, housing bubbles, near global recession, and so on constitutive of the GFC. This is, of course, not to say that no one has any morally responsibility. On the conception of collective moral responsibility as joint moral responsibility, each member of the salient group in question must have some degree of moral responsibility (jointly with the others).\footnote{For arguments against collectivist theories of collective moral responsibility which allow the possibility of collective moral responsibility without any individual moral responsibility, or with collective moral responsibility above and beyond aggregate (and/or joint) moral responsibility, see Seumas Miller, “Against the Moral Autonomy Thesis,” \textit{Journal of Social Philosophy} 38, no. 3 (2007): 389–409; and Miller and Makela, “The Collectivist Approach to Collective Moral Responsibility,” 634–51.}

Naturally, multiple individuals could be collectively causally responsible for some adverse outcome without any individual having any moral responsibility (notwithstanding his or her individual causal responsibility). Nineteenth-century—as opposed to, say, twenty-first-century—contributor to human induced harmful global climate change are a case in point; nineteenth-century contributors did not know, and could not have known, the harm they were causing. Moreover, even if a set of individuals do know that they are...
collectively causing harm, they may not be collectively moral responsible for that harm by virtue of not being able to organize themselves sufficiently to avert that harm, or at least unable to do so within the relevant time frame. This was arguably true in the late 1990s of government officials in relation to harmful human-induced climate change, even if it is no longer true.  

4. INSTITUTIONALLY EMBEDDING INDIVIDUAL AND COLLECTIVE MORAL RESPONSIBILITY IN FINANCIAL BENCHMARKS

The widespread and ongoing manipulation of financial benchmarks is a species of institutional corruption. Moreover, as I have argued elsewhere, the corrupt condition of an institution or institutional mechanism exists only relative to some moral standards, which are definitional of the uncorrupted condition of that institution, including the moral character of the persons in institutional roles. Consider the uncorrupted libor process. It consists of truthful, well-founded submissions being made by various banks and a correct calculation being made in accordance with the averaging procedure. This otherwise morally legitimate institutional process is corrupted if one or more of its constitutive actions are not performed in accordance with the process as it is rightly intended to be. Thus, to understate or overstate one’s estimations in the service of influencing the result of the process so as to enable one’s traders to make profits is a corrupt action. In relation to moral character, consider an honest submitter who begins to make false libor submissions under the pressure of a corrupt senior management or a corrupt culture among the bank’s traders. By engaging in such a practice, he risks the erosion of his moral character; he is undermining his disposition to act honestly.

Before proceeding further, it is important to clarify further the notion of institutionally embedding collective moral responsibility. It is also important to further clarify the relationship between individual and collective moral responsibility on one hand, and individual and collective institutional responsibility on the other. As a result, the relevant notion of the distribution of individual moral responsibilities in the context of the forms of collective moral responsibility in question will come into view. I note that our concern here is principally with prospective rather than retrospective moral responsibility.

Collective moral responsibility can enter into the picture at three points (at least). First, there might be a collective moral responsibility to establish an institution or institutional mechanism, for example, to establish some


51. Miller, Moral Foundations of Social Institutions, Chapter 5.

52. For more detail in relation to the following discussion, see Miller, Moral Foundations of Social Institutions, Chapters 2 and 4; and Miller, “Collective Moral Responsibility: An Individualist Account.”
financial benchmark or other such as libor. Second, there might be a collective moral responsibility to reform an institution or institutional mechanism, for example, to redesign libor so as to ensure it is not subject to manipulation. Third, there is the collective moral responsibility of the various participants in such an established or redesigned institution or institutional mechanism to realize its collective end(s) and, thereby, generate its collective good(s). In the case of financial benchmark corruption, it is primarily the second and third collective moral responsibilities that are in question.

Accordingly, prior to the redesigning of an institutional arrangement of the kind in question (e.g., libor), there is typically a collective moral responsibility to deal with some problem (e.g., institutional corruption). Moreover, those who have this collective, that is, joint, moral responsibility are quite often multiple and diverse—for example, submitters, bank managers, regulators, and members of the legislature. However, since the design and implementation of the institutional “solution” to the problem has not yet taken place, the collective moral responsibility of these agents is often relatively inchoate and, as a consequence, the accompanying individual moral responsibilities underspecified.

However, once the specific institutional arrangement—the joint institutional mechanism—has been redesigned and implemented matters are different. There is now not only a collective end which is a collective good (e.g., the provision of an uncorrupted interest rate benchmark), but also a specific institutional means to achieve this end (e.g., an independent administrator of the benchmark, an appropriate governance structure for the administrator, a reliable methodology for calculating the benchmark rates, and stringent oversight and disciplinary powers in relation to would-be manipulators). Importantly, the institutional rights and duties of the role occupants in this redesigned joint institutional mechanism have now been specified in a manner that—let us assume—ensures the scheme is no longer corrupted but rather reliably and consistently achieves its collective end. So the original somewhat inchoate collective moral responsibility to remedy the corruption (or other) problem has been discharged by means of a redesigned joint institutional mechanism which assigns specific institutional responsibilities.

Notice that whereas each institutional role occupant has an individual institutional responsibility (e.g., to provide accurate transactional data), it is the combination of all the contributing institutional actors (e.g., the providers of data, those who apply the methodology, the regulators of the administrator) that realizes the collective end of the (now presumably uncorrupted) joint institutional mechanism. Accordingly, each institutional actor is not only discharging his individual institutional responsibility; each is also (simultaneously) doing his or her part to jointly discharge the collective institutional responsibility of the joint institutional mechanism, for example, to provide an uncorrupted financial benchmark.

53. See Miller, Moral Foundations of Social Institutions.

54. The benchmark qua joint institutional mechanism also involves the users of the benchmark. However, users qua users do not have moral responsibilities vis-à-vis mechanism in the same sense.
Moreover, these individual and collective institutional responsibilities are also individual and collective moral responsibilities; or, at least, they are if we assume the joint institutional mechanism in question realizes a collective good, does not involve any rights violations, is fair and reasonable, and so on. Thus, in the case of Libor, the individual institutional responsibility of the submitters is also an individual moral responsibility. Again, the collective institutional responsibility on the part of submitters, managers, and so on in multiple banks, members of the administrative agency, and on the part of bank regulators, and so on—discharged by way of each discharging their individual institutional responsibilities jointly with the others—is also a collective (i.e., joint) moral responsibility.

It should now be evident what is meant by institutionally embedding collective moral responsibility. The original somewhat inchoate collective moral responsibility, and its accompanying underspecified individual moral responsibilities, have now been transformed by way of an institutional arrangement into a collective moral responsibility with specific content and an accompanying set of well specified individual moral responsibilities (the moral rights and duties definitive of the redesigned constitutive institutional roles).

Notice that the notion of collective moral responsibility in play here, that is, joint moral responsibility, applies vertically as well as horizontally (so to speak). It applies vertically in so far as the collective moral responsibility in question involves the joint actions of individuals at different levels in hierarchical organizations, for example, submitters and their managers. Here, there is a need to recall the conception outlined in Section 3 above of organizational action as multilayered structures of joint action. This conception makes possible the ascription of collective (joint) moral responsibility to members of an organization engaged in organizational action. Likewise the related conception of a joint procedural mechanism outlined in Section 3 makes possible the ascription of collective (joint) moral responsibility to participants in various subinstitutional mechanisms, such as the Libor benchmark-setting process.

Notice further that the distribution of individual moral responsibilities in a joint institutional mechanism mirrors the distribution of individual institutional responsibilities in that mechanism. Roughly speaking, each discharges his or her individual moral responsibility in so far as he or she discharges his or her individual institutional responsibility. Moreover, in doing so each contributes to discharging—jointly with the others—the collective moral responsibility (which mirrors the collective institutional responsibility of the mechanism).

Accordingly, the notion of the distribution of individual moral responsibilities typically in play is not essentially a quantitative one. So, in general, it is misleading to assume that there is some quantum of collective moral responsibility which is to be distributed by analogy with (say) the distribution of a stack of cement bags among a team of laborers in a loading bay—each laborer being required to load some minimum number of bags so as to ensure the whole stack is loaded. Rather, the distribution of responsibilities is to be thought of more in terms of the notion of a division of labor. For example,
it is the responsibility of some actors to make correct submissions and that of others to unearth benchmark manipulation if it is taking place.

Nevertheless, in contexts of collective institutional and moral responsibility, some individual institutional and moral responsibilities are more important than others; some participants have a responsibility to make a greater contribution than others. For example, the occupant of a position of institutional authority typically has—other things being equal—a greater extent of individual institutional and moral responsibility for institutional outcomes than one of her subordinates.

In general, whereas any given participant in such an institutional joint mechanism is only partially morally responsible for the realization of the collective good realized by the mechanism, each is, nevertheless, fully morally responsible for their own individual contribution. However, this is not necessarily the case. For example, a subordinate may have diminished individual moral responsibility for his institutional action which would have untoward moral consequences if he carried it out under a (lawful) instruction from a superior.

In this overall context of institutionally embedding collective moral responsibility, let us now turn to some of the specifics of the institutional redesign of the financial benchmarks in question—redesign undertaken to combat their corruption. Here, I reiterate that my notion of collective responsibility is that of relational individual responsibility; it is not the notion of collective responsibility which attaches to the collective per se and, therefore, as critics have pointed out, enables individuals to avoid or evade responsibility. I also note that Wheatley himself stressed the importance of collective responsibility to the integrity of the libor process.

The various benchmark corruption scandals we have been considering can be viewed in each case principally as a failure of collective moral responsibility at a number of levels and not, therefore, as simply an aggregate of failures of individual moral responsibility as, for example, the “rotten apple” theory would have it. Importantly, and as noted by the Wheatley Review, there is a collective institutional responsibility on the part of libor submitters to provide well-founded, truthful submissions and, thereby, arrive at correct libor rates. It was this collective institutional responsibility—and, given the moral significance in terms of the resulting harm, breach of trust, and so on, collective moral responsibility—which those who engaged in false submissions failed to discharge and, in so failing, corrupted the libor process. What is remarkable is that pre-Wheatley it was probably not a legal offense to engage in libor interest-rate rigging; evidently, bank robbery was regarded as one thing, but robbery by bankers quite another. So criminalizing libor interest-rate rigging is an obvious quite specific required piece of institutional redesign.


56. Wheatley, “Pushing the Reset Button on Libor.”
Institutionally embedding collective moral responsibility is primarily an exercise in respect of prospective, as opposed to retrospective, moral responsibility. Accordingly, it requires that matters of institutional redesign, implementation, and ongoing compliance be attended to.

At the micro level, there is a need to specify the collective good realized by joint institutional mechanisms such as benchmarks. In the case of financial benchmarks, such as libor and WM/Reuters reference rates, if methodologically sound and uncorrupted, they summarize complex transactional data in a manner that enables those relying on them to make well-founded financial judgments. However, the worth of these putative collective goods is itself dependent on the purposes served by the financial markets in question. If, for example, benchmarks were to be utilized purely or even primarily in the service of speculative trading, then, arguably, the integrity of benchmarks would be of questionable value because the financial practice which they helped to sustain was itself of questionable value.

Moreover, at the micro level, there is a range of structural and regulatory reforms that should be devised and implemented to combat corruption of financial benchmarks. As already noted, these include ensuring that the administrator is independent, the methodology for generating the benchmarks appropriate and reliable, and there is an adequate enforcement mechanism. The Monetary Authority of Singapore proposed a quite detailed set of measures in relation to administrator governance and enforcement in particular. They included criminal and civil sanctions for manipulating financial benchmarks, regulatory oversight of benchmarks deemed to have systemic importance, licensing of administrators and submitters of key benchmarks, establishing arrangements for monitoring and surveillance of benchmark submissions, codes of conduct for submitters, and the appointment of an external auditor to conduct annual independent review of submitter’s benchmark submissions.

Although such microstructural redesign of the joint institutional mechanism is necessary, for reasons outlined above it is not sufficient. There is also a need for macrostructural reform and a need also to address unhelpful elements of institutional culture. By way of concluding this article, I offer a brief description of some of the possible institutional redesign measures in these two areas.

In relation to macrostructural redesign, a number of problems and possible solutions are salient. Take lopsided power structures (e.g., banks that are too big to regulate) and the related problem of a small number of dominant banks able to unduly influence interest and exchange rates in specific markets. Here, there is evidently a need for downsizing, possibly by splitting the investment from the retail arm of banks to form two separate institutions. There may also be a need to provide additional resourcing to regulatory authorities and to give them more intrusive powers of investigation, if

57. I have discussed these in detail elsewhere.

58. Perhaps, in accordance with the so-called Volcker Rule originally within the Dodd-Frank Wall Street Reform and Consumer Protection Act but subsequently watered down.
they are to satisfactorily play their part in the joint effort to combat corruption. Here, I take it that combating corruption is a joint activity on the part not only of the regulator but also the regulated. Anti-corruption measures cannot possibly succeed if compliance with them is wholly dependent on the efforts of the personnel in enforcement agencies. There is also the possibility of mobilizing consumers and clients by way of facilitating class actions. The responses of the “victims” of corruption are important in combating it, as is the case in combating crime more generally.

Currently, the large global banks are market actors primarily driven by the profit motive. Contrary to current ideology, this is not inevitable. At any rate, in this current environment, the pervasive culture in these organizations—for example, among traders remunerated in large part on the basis of bonuses—tends to be reflective of this and tends also not to be sufficiently responsive to relevant ethical principles. So there is an issue of institutional culture change, albeit one that would depend in large part on macrostructural changes.

Whether or not the members of some organization internalize the desirable ends and principles of an organization—as opposed to undesirable ones—is in part a matter of institutional culture. Institutional culture is in turn dependent on the extent to which the collective moral responsibility to achieve desirable ends, and eschew corrupt practices, is embedded in the organization by way of explicit institutional mechanisms (e.g., formal continuing education programs in professional ethics, whistleblower protection schemes, remuneration systems that do not encourage excessive risk taking) and implicit practices (e.g., managers who acknowledge their mistakes, employees who are unafraid to voice their concerns). Accordingly, there are various measures that could be looked at in relation to institutional culture change at the organizational level (as well as, as already stressed, at the macro-institutional level).
Democracy and the European Central Bank’s Emergency Powers

JENS VAN ‘T KLOOSTER

One of the deepest questions faced by any constitutional order is how to reconcile the possibility of a state of emergency with the ideals of democratic governance and rule of law.

These questions were raised in a dramatic way as the effects of the Global Financial Crisis rippled across the world and reached the youngest of all the major central banks, the European Central Bank. As a direct consequence of the crisis, European banks received unprecedented bailouts from individual Member States. As an indirect consequence, European states themselves saw tax revenues drop, while uncertainty over the costs of future bailouts drove up borrowing costs. The euro became caught up in the destructive vortex of a bank–sovereign doom loop.

Unprepared for such events by its legal mandate, the European Central Bank (ECB) experimented with a wide range of policy measures, which took it to the very limits, if not beyond, the confines of its legal mandate. Despite explicit prohibitions in its mandate against lending to Member States, the ECB spent almost €220 billion on Greek, Irish, Italian, Portuguese, and Spanish bonds. These programs, whose permissibility was challenged but ultimately upheld in a 2015 ruling of the European Court of Justice (ECJ), make clear that the ECB has far-reaching, almost unstrained powers to act in the face of exceptional circumstances. When financial markets hinder its monetary policy, the ECB can do, in Mario Draghi’s words, “whatever it takes” to restore financial stability.

In this article, I describe and evaluate the emergency powers of the European Central Bank as exercised in the 2010–2012 Eurozone crisis. The circumstances of the crisis may have called for exceptional measures, but the dust has settled and the time has come to look to the future. I raise two democratic objections to the ECB’s current powers. First, although the European Court of Justice has sanctioned the creative legal justification put forward by the ECB, the existing
powers lack any meaningful democratic basis. Neither the ECB nor the ECJ is in any recognizable sense democratic. The European treaties received democratic consent in entirely different historical circumstances. Second, I show that the ECB faces almost no constraints on the use of its powers from a legal statute or checks and balances from other political agents. This makes the exercise of the emergency powers available to the ECB objectionably arbitrary.

Both objections invoke democratic values which many will accept without doubt for normal circumstances, but will be more hesitant to invoke during a state of emergency. Carl Schmitt and legal scholars influenced by his work argue that the exceptional circumstances of a state of emergency are simply incompatible with the ideal of the rule of law.1 Others, drawing on the work of A. V. Dicey, will argue that even in exceptional circumstances, the rule of law should continue to apply to executive decisions. All that is needed is for the judiciary to provide ex post checks and balances on the exercise of emergency powers.2

Against these authors, I argue for properly democratic checks and balances on emergency powers. To this end, I discuss the constitution of the Roman Republic and explain how emergency powers can remain effective while also subject to democratic checks and balances.3

At least in the case of the ECB, the possibility of a state of emergency does not require suspension of the rule of law.

In making these arguments, the article contributes to three debates. First, from the perspective of earlier debates on the state of emergency and the rule of law, the article puts forward a new account of how to deal with the potential conflict between the needs of a state of emergency and the requirement of democratic government and rule of law.4 I outline and defend a democratic approach. Second, the article contributes to debates in political philosophy and elsewhere over the future of central bank independence after the Global Financial Crisis.5

Third, the article contributes to debates over the future of the European Union and its perceived democratic deficit.6


3. My argument draws on Ferejohn and Pasquino (2004), See also, among others, Ackerman (2004) and Tushnet (2007) for other democratic approaches to the issue of emergency powers.


The article is structured as follows. In Section 1, I explain in what sense the ECB has emergency powers. First, I look at the Roman constitution to explain the legal concept and its historical origins. I then turn to the ECB and discuss its legal mandate, sovereign bond purchase programs, and the Gauweiler court case in which the legality of the program was challenged before the European Court of Justice, but ultimately upheld. I introduce the concept of a financial state of emergency to explain in what sense the Gauweiler ruling makes clear that the ECB has emergency powers.

In Section 2, I turn to a normative evaluation of the ECB’s emergency powers and raise two objections. First, the ECB lacks a clear democratic mandate for exercising its emergency powers. Second, due to clear legal provisions and its status as an independent institution, the emergency powers can be exercised in a way that is arbitrary.

In Section 3, I evaluate three alternative solutions to the democratic deficit created by the ECB’s emergency powers and argue for democratic reform. The first proposal is to revise the ECB’s legal mandate to enumerate emergency measures to be taken in a sovereign debt crisis. The second is an expanded role of the European Court of Justice in the judicial review of emergency powers. I argue for a third option, which is to introduce a more prominent role for the EU legislature in the emergency powers procedure. This option, so I argue, is best suited to address existing objections regarding the democratic legitimacy and arbitrariness of the ECB’s emergency powers.

1. THE ECB’S EMERGENCY POWERS IN THE 2010–2012 EUROZONE CRISIS

I will now argue that the extensive competences of the ECB in a financial crisis are best understood as emergency powers. To this end, I first explain the legal concept of an emergency power by tracing its origin to Roman law (Section 1.1). I then describe the ECB’s legal mandate (Section 1.2) and the events that led the ECB to initiate its sovereign bond purchase programs (Section 1.3). In Section 1.4 I discuss the final ruling of the European Court of Justice on the Gauweiler court case, in which the legal permissibility of the program was challenged. I conclude by explaining how the ECJ ruling assigns a wide range of emergency powers to the ECB in the event of severe disruption of Eurozone financial markets (Section 1.5).

1.1 What Are Emergency Powers?

The Roman constitution contained an elaborate system of checks and balances, which distributed political powers among two consuls, ten tribunes, a senate, and a popular assembly. The legal system protected citizens from prosecution without trial. The constitution contained emergency powers to sidestep these

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checks and balances in the event of a crisis. In exceptional circumstances, the Roman senate could direct the consuls to appoint a dictator for a period of up to six months. During that period, the dictator could suspend a right of appeal for serious sentences and use military force in any way he saw fit, which would not be permitted in normal times. After his term ended, the dictator was immune from legal prosecution, but was subject to informal evaluation for the virtues that he had displayed during the emergency (Wilde 2012).

As emphasized by Ferejohn and Pasquino (2004), the aim of the Roman state of emergency was conservative, in that the dictator was meant to use his powers only to protect and restore the constitutional order. The dictator was not permitted to make changes to existing law and was expected to resign after the emergency. Moreover, the dictator would be subject to criticism for extending the state of emergency or making use of more extensive powers than strictly required. The exercise of emergency powers, then, was only justified as required to protect the constitutional order itself.

In accordance with Roman usage, I define an emergency power in terms of two features. First, the political agent is prohibited from exercising these powers outside a narrowly defined state of emergency. In the case of the Romans, the exceptional powers of the dictator conflicted with the constitution’s checks and balances, especially concerning the use of military powers, and the demands of due process. Emergency powers allow a political agent to move beyond the rule of law as it applies in normal circumstances. Second, even in a state of emergency, the use of emergency powers is only permissible to protect the constitutional order that is the basis for its political power. In the case of the Romans, the dictator would use his powers to protect the constitutional order and resign when that threat subsided. The use of emergency powers is limited to doing whatever, but not more than, events require.

An appealing feature of the Roman constitution is that emergency powers were not held by one single agent, but distributed over the different Roman political agents. I will distinguish four independent legal roles within the state of emergency. First, the powers of the dictator are defined in the constitution. I will refer to this as the power-defining role. Second, the constitution assigns the power to call the state of emergency to the senate, whereas the consuls appoint the dictator. I will refer to these roles as power-enabling. Third, the dictator has the role of deciding what to do in order to address the state of emergency. To this end, an individual was appointed entirely outside the existing political institutions. I will refer to the role of actually deciding what to do in a state of emergency as the power-exercising role. Finally, neither the senate, the consul, nor the courts were able to end the state of emergency or punish the dictator for his actions during the state of emergency. It was left to the wider public to evaluate the decisions made by the dictator. I will refer to this role as the power-evaluating role.

The distribution of powers over different political agents is important for evaluating the emergency powers of the ECB. First, this will illustrate the comparative lack of checks and balances on the existing emergency powers of the ECB. Second, the Roman model will be important for improving the procedures for emergency powers.

1.2 The Legal Mandate of the ECB

To explain in what sense the ECB has emergency powers, I will now explain the legal mandate that is the basis of its legitimacy.

The European Central Bank, like all European Union institutions, is the product of the intergovernmental European treaties. The Treaty on the Functioning of the European Union (TFEU) contains the provisions that govern the ECB. It creates an independent central bank, whose primary role is to provide liquidity to the financial sector and to “maintain price stability” (TFEU 127) through its monetary policy. To guarantee that the ECB is able to pursue this mandate independently, the treaty prohibits EU political institutions from influencing its operations and prohibits the ECB from taking instruction from them (TFEU 130).

The treaty assigns a narrowly defined role as lender of last resort to the ECB. As a lender of last resort, a central bank lends to governments and to, financial and nonfinancial institutions who are illiquid in that they are temporarily short of means of payment but not insolvent. An economic agent is insolvent if it cannot meet its outstanding payment obligations with its assets and expected future revenues. Lending to an insolvent institution, so the traditional argument goes, merely covers up an unavoidable bankruptcy in the absence of direct cash transfers. For this reason, Article 18 of the Statutes requires that the ECB only provides credit in exchange for adequate collateral.

Complementing this more traditional provision, the Treaty also introduces constraints that are specific to the unique circumstances of the European Economic and Monetary Union (EMU). A defining feature of the EMU is its asymmetric two-pillar structure. Within the EMU, monetary policy is set at the level of the Union by the ECB, whereas the formulation of fiscal policy remains primarily a competence of the individual Member States. The treaties leave responsibility for the solvency of both individual Member States and their domestic banking sector to national governments. To this end, the European institution are explicitly banned from supporting the public expenditures of the Member States. Article 123 of the treaty bars the ECB from lending to Eurozone governments. Complementing Article 123, Article 125 prohibits Member States from lending to each other. It is in particular these latter provisions that set the stage for the Eurozone crisis.

9. Articles 127 to 133 and the ESCB and ECB Statutes annexed to it.
10. See Bordo (1990) for a historical discussion of the term.
11. For a discussion, see Amtenbrink and de Haan (2003) and Tuori and Tuori (2014, 30f).
1.3 The ECB in the Eurozone Crisis

The 2007–2008 Global Financial Crisis saw the European banking sector face dramatic losses. For banks to survive the crisis, it became clear, some form of public bailout would be required.

In the early years of the crisis, the European Member States essentially dealt with it individually. Between 2008 and 2014, European governments acquired bad assets from their domestic banking sector for a value of 5.3 percent of GDP and made direct fiscal transfers for another 2.1 percent of GDP.\(^\text{12}\) Expenditures differed considerably, with Ireland alone spending 25 percent of its GDP on bailouts.\(^\text{13}\) Compounding these direct costs, the indirect costs of financial market conditions and the economic downturn were much larger. The average Eurozone debt-to-GDP level rose from 65 percent of GDP in early 2008 to 92 percent at the end of 2014.\(^\text{14}\)

In countries such as Ireland and Spain, the public debt doubled in a two-year period.\(^\text{15}\)

In early 2010, the Eurozone crisis entered a second phase when the problems of the domestic banking sectors gave rise to doubts about the solvency of individual Member States. At this point, domestic banking sectors and sovereigns entered into what has been described as a bank–sovereign “doom loop.”\(^\text{16}\) The doom loop is a self-enforcing negative spiral between the credit ratings of sovereign bonds issued by individual Member States (as opposed to bonds issued by commercial bodies) and their domestic banking sector.

To explain the financial market dynamic behind the doom loop, I will briefly discuss the determinants of bond pricing. A bond is a claim to payment in the future. These payments consist of the interest (or “coupon”) paid regularly to the bond holder, and the sum of money that is repaid at maturity (the “principal”). Because repayment takes place only in the future, the value of a bond is merely theoretical until then. The theoretical value of a bond is the sum of the present value of all expected future coupon payments plus the present value of the principal at maturity. Insolvency risk reduces the present value of these future payments. Consequently, a rise in insolvency risk reduces the theoretical value of bonds that have already been issued. Market prices tend to approximate theoretical values, so that a rise in perceived solvency risk reduces the market value of sovereign bonds.\(^\text{17}\)

Sovereign bonds are owned by banks as part of their capital buffers. The value of sovereign bonds is therefore important for the solvency of the banking sector. Perceived increases in sovereign default risk lower the value

\(^{12}\) ECB 2015.
\(^{13}\) Idem.
\(^{14}\) Idem.
\(^{15}\) Idem.
\(^{16}\) The concept was introduced by Alessandri and Haldane (2009).
\(^{17}\) For an overview of the theory of bond pricing, see Brealey, Myers, and Marcus (2002).
of sovereign bonds, thereby reducing the solvency of the banking sector. Thus, doubts about the solvency of Member States reduced the solvency of their domestic banking sectors.

Doubt about the solvency of the banking sector, in turn, increases the perceived solvency risk of sovereigns. In the event of a large-scale default of its banking sector it is unlikely that a state can repay its bondholders. Therefore, doubts about the solvency of the domestic banking sector also reduce the credibility of states. This increases the interest rates that states pay in sovereign bond markets up to a point where these interest rates themselves become a threat to the solvency of the state. The banking sector and the state get locked into a self-enforcing negative spiral, which can drive both into bankruptcy.

A bank–sovereign doom loop is rare in developed countries because states that borrow money in their own currency can always repay their bondholders. They merely need to order their central bank to print the money for them. As explained in Section 1.1, this was not a permissible course of action within the existing legal framework of the European treaties, which both prohibit states from instructing the ECB and prohibit the ECB from lending to Member States.

Despite these legal obstacles, the ECB did eventually, albeit initially reluctantly, intervene in bond markets. From May 2010 onwards, the ECB started buying Greek, Portuguese, and Irish bonds as part of its “Security Markets Program” (SMP). In 2011, this program was extended to Spanish and Italian bonds, leading ECB executive board member Jürgen Stark to resign in protest. At the end of the program in February 2012, the ECB had spent €66 billion on Greek, Portuguese, and Irish bonds, €99 billion on Italian bonds, and €43.7 billion on Spanish bonds.

In the spring of 2012, the crisis led the ECB to replace its SMP program with a new program called “Outright Monetary Transactions” (OMT), which was explicitly announced as unlimited with respect to the volumes of bonds that the ECB would buy to stabilize bond markets. Around the time of the OMT program, ECB president Mario Draghi put the efforts of the ECB in the context of a wider aim, namely that of saving the euro. As he famously put it,

We think the euro is irreversible. And it’s not an empty word now, because I preceded saying exactly what actions have been made, are being made to make it irreversible. But there is another message I want to tell you. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough. (ECB 2012)

After this announcement, sovereign bond markets rapidly stabilized, thereby ending this phase of the crisis.


1.4 The OMT before the European Court of Justice

Due to the treaty’s Article 123 prohibition of monetary financing, the legal permissibility of the SMP and OMT programs was hotly contested. In this section, I discuss the high-profile Gauweiler court case on this issue to explain in what sense the programs are an exercise of emergency powers.

The European treaties leave extensive discretion to the ECB in interpreting its mandate, but also leave a role to the European Court of Justice in reviewing the legality of the ECB’s operations. The legality of the OMT program was first challenged in the German constitutional court in Karlsruhe, which in February 2014 referred the case to the European Court of Justice.20

The litigants made a range of objections to the OMT program. I focus on the claim that the OMT program was not part of the competences assigned to the ECB by the treaty.

In its defense to the Karlsruhe court, the ECB argued that the OMT program fell within its mandate for maintaining price stability for two reasons. First, the Eurozone crisis interfered with the implementation of the ECB’s monetary policy. Monetary policy is implemented by setting interest rates in short-term money markets. Short-term money markets then “transmit” these interest rates to long-term capital markets, which in turn influence the real economy and price levels. According to the ECB, the Eurozone crisis disrupted the transmission mechanism of monetary policy. Second, the break-up of the euro as a whole would also, quite obviously, hinder the ECB from maintaining a stable price level within the Eurozone. For these reasons, so the ECB argued, the OMT program should be seen as part of its monetary policy mandate.

The ECB’s justification of the OMT program was, in outline, accepted by the ECJ in its final ruling of 2015. The court agreed that the transmission mechanism is an essential precondition for the ECB to implement its monetary policy. Therefore, the OMT program is indeed part of its monetary policy mandate (ECJ Case C-62/14, 32–45). But, as part of its ruling, the ECJ also underlines the limitations of its own role in reviewing a decision by the ECB. The ECJ leaves the decision on whether the OMT is proportionate, barring obvious inadequacy, to the ECB itself. In the words of the ruling,

it does not appear that that analysis of the economic situation of the euro area … is vitiated by a manifest error of assessment. … The fact that that reasoned analysis has been subject to challenge does not, in itself, suffice to call that conclusion into question, since, given that questions of monetary policy are usually of a controversial nature and in view of the ESCB’s broad discretion, nothing more can be required of the ESCB apart from that it use its economic expertise and the necessary technical means at its disposal to carry out that analysis with all care and accuracy.21

21. ECJ Case C-62/14, 74–75.
It is then, for the ECJ, up to the ECB itself to decide what measures are required in the event of a crisis.

1.5 What Are the ECB's Emergency Powers?

As explained in Section 1.1, emergency powers are competences of a political agent that it is (i) only allowed to exercise in a crisis and must be used to (ii) protect the constitutional order which the political agent is part of. I now explain that the current treaty assigns emergency powers to the ECB.\(^{22}\)

Even if, in contrast to Roman law, there are no explicit emergency power provisions in the European treaties, the ruling of the ECJ makes clear that Article 127 does grant such powers to the ECB. The emergency powers become available when financial market events make it impossible for the central bank to pursue its monetary policy mandate. In the event of a crisis, the scope for permissible operations by the ECB changes dramatically. A financial crisis is one possible trigger, but it can take the form of any severe disruption of Eurozone financial markets that undermines the transmission mechanism or the future of the single currency. I will refer to any circumstance that requires the ECB to act so as to restore its very ability to pursue monetary policy as a financial state of emergency.\(^{23}\)

In normal circumstances, the ECB already has considerable discretion. Many of the ECB's unconventional measures should not be understood as an exercise of emergency powers in the sense at issue here. Consider the ECB's Asset-Purchase Programme (APP), also known as Quantitative Easing or "QE." Despite the impact and the novelty of these tools, the goal that the QE program pursues as well as the instruments used fall within its mandate in normal circumstances. The ECB pursues QE as part of its mandate for maintaining price stability, which its Statutes permit it to do by trading in any "claims and marketable instruments, whether in euro or other currencies" it sees fit.\(^{24}\) Moreover, QE is not in any meaningful sense conservative. It does not serve to restore the existing order from an external threat. It is merely an operation that is licensed by that order and part of how it is supposed to function. In this sense, QE does not constitute an emergency power, but merely the exercise of the ECB's monetary policy function in more demanding economic circumstances.

The OMT program does constitute an emergency power in the relevant sense. First, lending to sovereigns would not be legally permissible for the ECB outside a financial state of emergency. In normal circumstances, the ECB could not argue that its mandate for price stability requires it to lend to sovereigns. Accordingly, such operations would not be part of its

\(^{22}\) See supra note 6 for authors who discuss the Eurozone crisis from a perspective of emergency powers.


\(^{24}\) ECB Statutes 18.
competences. Moreover, under Article 123, the ECB is prohibited from using its credit and deposit facilities to support the public finances of individual Member States. In its ruling, the ECJ explicitly states that it would normally not be permissible for the ECB to use loans to support the fiscal policies of Member States. It is only in the context of a financial state of emergency that the law assigns these powers to the ECB.

Second, the ECB’s powers are also conservative in that they are to be used to end the financial state of emergency. The ECB is only permitted to perform financial market operations like the OMT program with the aim of restoring its ability to pursue monetary policy. The use of its credit and deposit facilities with any aim other than directly or indirectly securing the stability of the currency would, in light of the ECJ ruling at least, be illegal.

In claiming that the ECB has emergency powers, I do not want to claim that the ECB is entitled to do whatever it takes to address a crisis. Where individual safety, or even the very existence of the state is threatened, emergency powers raise deep moral questions. Consider Walzer (2006, 251f) and his claim that in a supreme emergency such as a war in which the very existence of civilization is under threat, moral constraint on the exercise of military force no longer applies. The normative question that such extreme circumstances raise is whether it can ever be morally permissible to act against the fundamental rights of individuals. The sense of emergency powers at issue here is procedural, in that it raises the question whether the suspension of existing legal procedures fits with the ideals of democratic governance and rule of law.

2. A NORMATIVE EVALUATION OF THE ECB’S EMERGENCY POWERS

I now turn to the normative evaluation of the emergency powers of the ECB. As explained in Section 1, the ECB was designed to serve as an independent institution with a narrow price stability mandate. The events of the crisis have forced the ECB into the role of lender of last resort to governments. But as an institution that was never intended to pursue a policy like OMT, the ECB lacks both a democratic mandate and adequate political procedures for this role. First, its emergency powers have not been conferred on the ECB through a democratic process (Section 2.1). So far at least, it is something decided between the ECB and the ECJ. Second, their exercise is to a considerable degree arbitrary in that the ECB has extensive discretion over both the goals that it pursues and the instruments it uses (section 2.2). It also faces no checks and balances in the form of effective constraints from other national or European level institutions. I will not try to ground these objections in deeper moral or political values. Rather, I take these objections to invoke widely accepted normative criteria for evaluating political procedures. Democratic procedures
are an important component of more instrumentalist accounts of political legitimacy as well as contributing to ideals of political equality and popular sovereignty.  

2.1 The Absence of a Democratic Mandate for the ECB’s Emergency Powers

The exercise of political power has democratic legitimacy, in the sense at issue here, if the power is assigned to a political agent by consent from citizens or their elected representatives. This consent should have both a prospective dimension in that it requires authorization from citizens to exercise political power. It should also involve a retrospective dimension in that citizens can hold those who exercise power to account. I will assume here that elections have a crucial role in providing political agents with democratic legitimacy.

As an institution led by unelected officials, the democratic legitimacy of the ECB’s monetary policy operations derives primarily from the European treaties. In their decision to join the euro and ratify the European treaties, the Member States delegated the power over monetary policy to the ECB. Because the Treaty on the Functioning of the European Union was ratified by the elected governments of the Member States, it can confer democratic legitimacy on at least some operations of the ECB.

The emergency powers of the ECB are not explicitly mentioned in the Treaty as ratified by the Member States, but derive from an act of interpretation on the side of the ECB. As discussed in Section 1.1, the European treaties sought to establish an independent central bank with a narrow mandate for the pursuit of price stability. The treaties do not contain any articles that are meant to assign emergency powers to the ECB. In general, the ECB did not receive any legal competence for nonmonetary economic policy issues, which are to remain a national competence.

Because there is no explicit mention of these powers in the treaties, the mere act of ratification does not establish that elected governments consented to the exercise of emergency powers. Although the ECJ has ruled that the exercise of emergency powers is permitted by the treaties, it is perfectly possible to take a different view on that interpretation. In the interpretation of the mandate prevalent before the crisis, the legal mandate was thought to place narrow constraints on both the goals and the instruments of monetary policy. As the ECB itself explains in one of its pre-crisis publications,

25. For an argument in favor of the former, see Arneson (2003). For the latter, see Christiano (1996) and Richardson (2002).

26. On democratic legitimacy and the EU, see, for example, Weiler, Haltern, and Mayer (1995), Majone (1998), and Moravcsik (2002). For an overview, see Føllesdal (2006). The claim that a treaty is required to confer democratic legitimacy on EU competences is accepted by all these different authors. They disagree over whether a treaty is sufficient for democratic legitimacy, but I only rely on the weaker claim here.
Competency for monetary policy is transferred within the limits and the conditions of a mandate which clearly defines the objective of monetary policy and thus limits the amount of legally permitted discretion that the decision-making bodies of the ECB can use in conducting monetary policy. (Scheller 2006, 127)

In ratifying the treaties, the Member States at best unknowingly agreed to the ECB’s emergency powers, but they did not in any meaningful sense consent to them.

The ECB’s emergency powers, then, do not derive democratic legitimacy from the treaty as consented to by the Member States. Rather, they are based on the treaty as understood in the creative interpretation of the ECB and sanctioned by the European Court of Justice. But neither of these institutions is in any recognizable sense democratic. In this sense, the European treaties only provide the ECB with democratic legitimation for its conventional monetary policy operations, but not for its emergency powers.

The absence of explicit consent at the time of ratifying the treaties does not preclude that later decisions and statements of governments provide some form of democratic legitimacy. A treaty is never an immutable legal text, as the Member States knew when they signed it, in that it was subject to interpretation by the ECB and review by the ECJ. Accordingly, it could be argued that the absence of protest from the Member States implies a form of implicit consent. On this view, the fact that governments have not sought to stop the ECB is sufficient to confer democratic legitimacy on its emergency powers.

I have three reasons to deny that later decisions and statements of governments provide the emergency powers of the ECB with democratic legitimacy. First, the mere fact that governments have not revised the treaties does not mean that they support their current interpretation. Revision of the European treaties is a long and painful process. In the current composition of the EU, ratification requires consent from 69 distinct political bodies. The Lisbon procedure involved three queens (Denmark, the Netherlands, and the United Kingdom), two kings (Belgium and Spain), and a duke (Luxembourg). Second, Member States have clearly objected to both the OMT program and other emergency measures of the ECB. The Greek Syriza government is the most obvious example, but in the past years all governments that were subject to emergency measures have expressed their discontent over the expanded powers of the ECB in some form or another. The extent of disagreement has been limited by what is a crucial third consideration. Member States that received emergency support were vulnerable and therefore not in a good position to object to the exercise of these powers. It is accordingly not clear that the absence of dissent is a clear sign of consent, or mere grudging acceptance.

For the treaties in their current form to provide a democratic mandate for the ECB’s emergency powers, a formal decision to endorse these powers is required. Preferably, that decision would take the form of an explicit mandate in the treaties. This raises the question whether the Member States should be willing to retain the ECB’s emergency powers or whether the
experience of the crisis should lead us to rethink the existing legal mandate. I now turn to reasons to modify the ECB’s current emergency powers.

2.2 The Arbitrariness of the ECB’s Emergency Powers

The existing legal literature on emergency powers revolves in part around the question to what extent and by what means it is possible to limit arbitrary exercise of power.\(^\text{27}\) The state of emergency allows the sovereign to diverge from the rule of law as it applies in normal circumstances. This creates the risk that political agents act entirely as they see fit. As I will argue here, although the emergency powers of the ECB are in a legal sense not outside the law, their exercise nonetheless has a high degree of arbitrariness. I first explain what I mean by arbitrariness (2.1.1) and then explain that the ECB’s emergency powers are arbitrary in that they are not constrained in either goals or instruments (2.2.2) or subject to effective checks and balances (2.2.3).

2.2.1 Arbitrariness

Exercise of power is, following Frank Lovett, arbitrary if it is not “not reliably constrained by effective rules, procedures, or goals that are common knowledge to all persons or groups concerned” (Lovett 2012, 139).\(^\text{28}\) Rules act as reliable constraints if conditions are in place to ensure that they are observed by the political agent. But effective rules are only one way in which the exercise of powers can be nonarbitrary. What is decisive is that the constraints are reliable in the sense that it is not just up to the agent to decide what to do. In this regard, non-arbitrariness requires either substantive constraints in the form of a legal statute or checks and balances from other political agents, or, most likely, a combination of both. For the constraints to be public knowledge, as Lovett requires the exercise of power must be in accordance with rules agreed on within the political community and through the procedures that govern the exercise of power within that community. In emphasizing the procedural aspects of non-arbitrariness, Lovett does not invoke any substantive constraints on the exercise of power in terms of the interests of those affected by the decisions or their political beliefs.\(^\text{29}\)

I will follow Lovett’s definition of arbitrariness here.

In practice, the demand of non-arbitrariness requires that political agents should either face effective legal rules which are enforced by courts. Alternatively, other political agents must hold decision makers to account. Where rules are less strict, there need to be more checks and balances. Conversely, where rules and goals are clear and unambiguous, as central banks tend to claim

27. See, for example, Dyzenhaus (2006, 2), Ackerman (2004, 1066), and Cole (2004, 1785).

28. Frank Lovett proposes his concept of arbitrariness in the context of what is known as a neo-republican conception of liberty. My argument merely assumes that arbitrariness is an objectionable feature of political procedures, an assumption I take to be very widely accepted.

29. In contrast to, for example, Pettit (1997) and Richardson (2002).
with regard to their monetary policy mandate, checks and balances can be less stringent. Political power is arbitrary if it is neither constrained by rules nor by effective checks and balances.

2.2.2 Limited Constraints on Emergency Powers

The ECB faces almost no constraints on its emergency powers in the form of rules that define the state of emergency or permissible means to address it. In this sense, the emergency powers of the ECB fit Dyzenhaus’s concept of a legal gray hole. A legal gray hole is “a legal space in which there are some legal constraints on executive action—it is not a lawless void—but the constraints are so insubstantial that they pretty well permit government to do as it pleases” (2006, 42).

First, the range of events that can be interpreted as a financial state of emergency is potentially very large. In light of the ECB’s justification of OMT, it is sufficient that circumstances are such that the transmission of monetary policy is hindered in a way that precludes maintaining price stability. This argument easily extended to a wide range of events. Consider first other financial markets that have a crucial role in the implementation of monetary policy. Disturbance of short-term money market and longer term capital markets disrupts the transmission mechanisms and thereby provides the ECB with a license to intervene. Moreover, while the justification of the ECB invokes a disruption of the transmission mechanism, there are many other ways in which one could connect the price stability mandate to emergency measures. Consider a situation in which Eurozone financial markets are disrupted by a balance of payment crisis of one of the Member States. That situation too could count as a financial state of emergency.

Second, the range of means available to the ECB in overcoming the state of emergency is almost unconstrained. The ECB Statutes prescribe that it should pursue price stability by trading assets in financial markets or providing loans to credit institutions and other financial market participants. Although this could be taken to place some limits on permissible emergency operations, Article 20 permits a two-thirds majority of the Governing Council to “decide upon the use of such other operational methods of monetary control as it sees fit.” Moreover, even Article 18 does not obstruct the ECB from directly intervening in the real economy. Indeed, the ECB has vacillated on the question whether direct cash handouts (or “helicopter money”) fall within its legal mandate.

The emergency powers of the ECB do not just consist in the financial market operations themselves, but also in the conditions that attach to them. In 2011, the ECB sent letters to the Italian and Spanish governments with suggestions for detailed economic reforms. In the case of Italy, the SMP

30. As an example of the latter, Lovett invokes the monetary policy mandate of the US Federal Reserve. See Conti-Brown (2016) for an account of how extensive its discretion actually is.

31. ECB Statutes, Article 18.
program was briefly halted and only continued after President Berlusconi had resigned and transferred power to the unelected Mario Monti. These informal means of political power are also part of the instruments available to the ECB for dealing with emergencies.

### 2.2.3 No Checks and Balances

In the absence of substantive legal constraints, it is still possible that the use of the emergency powers of the ECB is not arbitrary. This would be the case if such powers are subject to sufficient constitutional checks and balances. In creating checks and balances, according to James Madison in *The Federalist* No. 51, “the interior structure of government” is designed so that “its several constituent parts may, by their mutual relations, be the means of keeping each other in their proper places” (Hamilton, Madison, and Jay [1788] 2003, 251). Political powers are subject to checks and balances if other political agents are able effectively to sanction and prohibit actions by that agent. In the absence of a European demos, checks and balances have a crucial role in preventing arbitrary exercise of power by European institutions.

An influential current in thinking about emergency powers holds that the very idea of emergency powers is antithetical to any effective constraints by the rule of law. In formulating this worry, these authors explicitly draw on the works of the German constitutional lawyer Carl Schmitt. Even if the law prescribes what to do, the circumstances of a state of emergency, or in Schmitt’s vocabulary the “state of exception,” is incompatible with effective constraints on political power. While I do not want to reject Schmittian worries entirely, I do not think that the state of emergency precludes the existence of checks and balances. I will therefore first explain in what sense emergency powers can be subject to checks and balances. I then argue that these are currently lacking for the emergency powers of the ECB.

To see that emergency powers can be subject to checks and balances, consider again briefly the Roman model. As explained in Section 2.1, the procedure for the exercise of emergency powers assigns different roles to different political agents. The power-defining role goes to the constitution, the power-enabling role goes to the senate and the consuls, the power-exercising role goes to the dictator and, finally, the power-evaluating role goes to the wider public. It is, accordingly, very well possible to make emergency powers subject to at least some checks and balances, even if their exercise remains in the hands of one political agent.

In contrast to the Roman constitution, the ECB is the decisive actor in all four roles involved in the exercise of its emergency powers. First, concerning the power-defining role, while the mandate is assigned to the ECB, it has extensive freedom in how to interpret it. In this context, it is

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33. See for example, Moravesik (2002, 605), Curtin (2009, 48f), and Piattoni (2015, 246f).
34. See supra note 1.
Table 1. Overview of Political Procedure for the Exercise of Emergency Powers (EL: European Legislature)

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again important to remember the reluctance of the ECJ to review emergency measures. As discussed in Section 1.4, decisions on proportionality are left to the ECB as long as it does not make “a manifest error of assessment.” This means, second, that the ECB is also free to decide how to exercise its emergency powers. Third, it is up to the ECB to decide in what circumstances it can move beyond its normal monetary policy brief. Finally, there is currently no adequate procedure to evaluate the exercise of political power by the ECB. The ECJ does not judge proportionality and, although the ECB is accountable to the European Parliament, this does not involve, as was also the case under Roman law, any means of sanctioning.

Thus, while the example of Roman law shows that it is quite possible to make emergency powers subject to checks and balances, these are currently lacking in the case of the ECB.

### 3. DEMOCRATIZING THE ECB’S EMERGENCY POWERS

The objections raised in Section 3 concern procedural qualities of the ECB’s emergency powers. The ideals of democratic legitimacy and non-arbitrariness are things that many would accept without question for political decisions in normal times, but be more hesitant to invoke during exceptional circumstances. I will now investigate whether an alternative is available to the status quo that does not undermine the ability of the ECB to respond in a sufficiently flexible way to a financial state of emergency. To this end, I discuss and evaluate three proposals for limiting the undemocratic and arbitrary exercise of the ECB’s emergency powers. The options are as follows: first, revision of the existing legal mandate to define and constrain the permissible use of emergency powers (3.1); second, extending the role of the European Court of Justice in evaluating the use of the emergency powers (3.2); and I argue for a third option, which is to give a crucial role to the European legislature (3.3). Table 1 provides an overview of the status quo and its alternatives.

#### 3.1 Revision of the Mandate

The most straightforward way to address the issue of democratic legitimacy is to revise the European treaties to explicitly sanction the ECB’s existing emergency powers. For example, a provision could be added to the mandate which stipulates that in the event of (severe) disruption of financial markets, the governing council can decide on the use of such other operational methods of market stabilization as it sees fit. I will refer to such a clause as a sanctioning clause, in that it would leave the current emergency powers of the ECB as they are and merely provide a more explicit legal mandate for exercising these powers.

A sanctioning clause would only partially address the worry of democratic legitimacy and do very little to address the arbitrariness objection. A sanctioning clause would leave the rules, procedure, and goals that constrain the ECB’s emergency powers exactly as they are. In this sense, the emergency
powers clause would remain a legal gray hole. Democratic consent to the existence of a legal gray hole is not the same as democratic consent to any particular exercise of power made possible by that gray hole. The exercise of emergency powers by the ECB is currently arbitrary in the sense that such powers are not reliably constrained by effective rules, procedures, or goals. A legal gray hole would also leave this situation as it is.

A revision of the mandate would therefore need to go beyond a mere sanctioning clause. The required revisions would need to reliably constrain the powers exercised by the ECB and the goals that it can permissibly pursue. I will refer to such constraints as an authorization clause. An authorization clause enumerates different states of emergency, instruments to use in these circumstances, and goals to pursue. If the authorization clause is sufficiently stringent, it will limit the extent to which the exercise of powers by the ECB is arbitrary. It will bind the exercise of power through proving more clear rules. Because the rules are clearer, the ECJ can also take up a more prominent role in reviewing ECB emergency decisions.

The major worry that a proposal along these lines faces is that a detailed authorization clause will not adequately anticipate emergencies. In the design of a constitution, it is possible to anticipate some states of emergency, such as a military threat, because they have happened in similar ways in the past. It is known that they call for the use of particular means (military force) to achieve a well-defined end (ward off the foreign threat). Not all states of emergency are of this kind and, in fact, it is the unanticipated emergencies for which emergency powers are most needed. Financial states of emergency such as financial and sovereign debt crises will often be of this kind.

A crisis need not be unforeseeable to preclude dealing effectively with it through an authorization clause. In talking of unanticipated emergencies, I want to avoid claiming that emergencies are unforeseeable as Carl Schmitt sometimes suggests (e.g., [1922]2005, 5–7). To claim that an emergency is unforeseeable implies that there are pervasive epistemic barriers to knowing that an emergency of that kind can occur. I think this is rarely the case. In fact, focusing on the Eurozone crisis, I found several authors who point to the risks of a sovereign debt crisis in the context of EMU, even if no one invokes the bank–sovereign doom Loop. In this sense, previous crises were not in any strict sense unforeseeable.

Rather, the issue is that the legislative process cannot be assumed to adequately anticipate these crises. If a crisis is not adequately anticipated in drafting the rules and goals with which the legislature seeks to constrain emergency powers, this may hinder their exercise in a crisis. Having already

35. For a recent detailed articulation of this worry for the general case of a state of emergency, see Gross and Ní Aoláin (2006, 17–109).

36. Jonung and Drea (2010) show that skepticism about the euro was a widely held view among US economists in the 90s. See Parguez (1999) for a detailed account of the structural weaknesses of the euro.
failed to foresee the bank–sovereign doom loop in the drafting of the Maastricht provision, it would be unwise to assume future emergencies could be adequately anticipated.

A legal article that would effectively constrain the operations of the ECB in a state of emergency would in at least some cases also undermine its ability to deal effectively with those circumstances. Thus, a revision of the mandate would either merely sanction the current arbitrary powers of the ECB or unduly constrain its ability to act in the face of a financial state of emergency.

I conclude that regulating the ECB’s powers with revisions to its legal mandate is unpromising. I will now turn to proposals that introduce checks and balances in the constitutional procedure for the exercise of emergency powers.

3.2 Extended Justiciability

A long tradition of legal thought on emergency powers assigns a crucial role to the legislature for placing checks and balances on the executive in a state of emergency. Following Dicey, these authors argue that emergency powers should be evaluated as subject to the rule of law just like other executive decisions. 37

A recent exponent of this view is David Dyzenhaus. 38 Dyzenhaus recognizes that judges have, in practice, been very reluctant to scrutinize executive decisions. 39 As we have seen in the OMT case, judges tend to evaluate the actions of the executive in terms of their positive legal legitimacy, but not in terms of any more substantive moral criteria. As a consequence, they provide limited checks and balances to executive decisions in a state of emergency. By giving up their narrow focus on positive law, according to Dyzenhaus, judges can make an important contribution to upholding the rule of law in a state of emergency.

Applied to the case of the ECB, an extended role for judicial review requires a more extensive role for judicial review by the European Court of Justice. 40 For example, the ECJ would apply a more thorough proportionality test regarding the appropriateness of the instruments used to deal with the emergency situation. This proposal would be in line with the statement of the German Federal Constitutional Court that lack of democratic legitimacy should “give rise to restrictive interpretation and to particularly strict judicial review of the mandate of the European Central Bank.” 41

There are a number of reasons why the ECJ is not the right institution to place checks and balances on the emergency powers of the ECB. For one, historical experiences with courts should make us pessimistic about their ability

37. See supra note 2.
40. See Goodhart and Lastra (2018) for a recent exposition of this view.
41. BvR 2728/13, 187.
and willingness to provide a counterweight to executive power. Dyzenhaus addresses this problem by rejecting a doctrine of legal positivism that he takes to inform such reluctance, but that is an answer on the level of theory. It is not clear what sort of cultural and professional changes would be required to create a more activist judiciary. Moreover, even if the ECJ judges, who are not always shy of activism, would be willing to do this, it not clear that the ECJ is the right institution for the role. First, there is a considerable asymmetry of expertise between constitutional judges and an independent central bank. The political issues involved in setting monetary policy are not primarily legal and it is therefore not part of legal expertise to adjudicate them. For review to be properly judicial, the legal criteria by which central bank operations would need to be spelled out in more detail. The ECB mandate is currently so broad as to allow a very wide range of operations to fall within its legal remit. But narrowing down what operations are permissible in a crisis brings up the Schmittian specter of inadequate anticipation. If, in contrast, the judicial review would involve considerable interpretation of the mandate on the side of the ECJ, there is a threat of arbitrariness. The letter of the law provides no answer and it is down to the whims of the judge what the central bank is or is not permitted to do. Moreover, the judiciary would only provide an _ex post_ review of the exercise of power. This does not address the current lack of checks and balances in the decision on the state of emergency and the definition of powers available to the ECB in these circumstances. Finally, because the ECJ is itself an unelected institution, this proposal would not solve the issue of democratic legitimacy.

I conclude that, even if more extensive judicial scrutiny would be an improvement over the status quo, this proposal does not adequately address the problems of democratic legitimacy and arbitrariness.

### 3.3 Legislative Approval and/or Legislative Powers

I now turn to two options for introducing democratic checks and balances on the ECB’s emergency powers.

The most democratic procedure on the EU level is that of the ordinary legislative procedure. The legislative procedure requires approval of both the European Parliament (as the direct representative of the European citizens) and the Council of Ministers (composed of members of the elected national governments). Although the independence granted to the ECB by Article 130 TFEU precludes this procedure having any authority over the ECB, it is possible to amend it so as to make some competences conditional on legislative approval.

Consider first the option of revising the ECB mandate so that the epistemic decision over what constitutes a state of emergency is made through

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42. For more recent versions of arguments along these lines see Posner and Vermeule (2011). Balls, Howat, and Stansbury (2016) propose that a committee chaired by the government takes control of the central bank during a crisis.
the ordinary legislative procedure. The EU legislature would call the state of emergency that triggers the emergency powers and have a role in deciding the period over which it remains in place, either through defining features or setting a particular time span. Only when the emergency powers article has been triggered can the ECB move away from its narrow mandate for monetary policy operations. It is left to the ECB to decide what the state of emergency requires, so that it retains the power-exercising role in the state of emergency. In this sense, the ECB retains operational independence in dealing with the crisis, but it cannot by itself decide when to exercise its emergency powers. Francesco Papadia and Tuomas Välimäki (2018), for example, argue that during a financial state of emergency, central banks should return to parliament to ask it for permission to prioritize financial stability over price stability. This proposal is modest in that it still leaves the central bank with considerable independence in deciding how to deal with the crisis. Following such a proposal, the OMT program would have been decided by the ECB, but only after the European legislature had decided that the Eurozone crisis required it to move beyond its narrow mandate. I call this proposal “legislative approval.”

A second option is to devise a procedure in which the ECB itself calls the state of emergency, but where the exercise of power is in part delegated to the EU legislature. On such a proposal, after the ECB calls the state of emergency, the EU legislature issues regulations for the ECB to execute. This proposal would involve a more substantial limitation to central bank independence in that the ECB would lose some of its operational independence during a crisis. Following this proposal, it would be up to the ECB to decide that the Eurozone crisis constituted a state of emergency. It would be up to the EU legislature to propose something like the OMT program. I call this proposal “legislative power.”

These democratic proposals address the shortcomings of revision of the mandate and expanded justiciability. First, the procedure provides robust checks and balances on the exercise of emergency powers. Because the epistemic and the power-exercising role are no longer shared by the same political agent, emergency powers are no longer entirely at the discretion of one agent. The exercise of these powers is conditional on permission from the political agent in the epistemic role. Moreover, that agent can revoke the state of emergency so as to undo the expansion of competences. In this sense, there are political agents who can effectively sanction and prohibit the use of emergency powers.

Second, the procedure has more obvious democratic elements. My proposal does not address the deeper democratic deficit of the EU. It does provide for the most extensive democratic accountability available within an EU context. Although the exercise of emergency powers remains to some extent an executive affair, the European Parliament and the elected officials of the Member States are authorized by citizens to act and are accountable for their actions to their electorate. Introduction of democratic political agents in the procedure thereby creates a further level of checks and balances on emergency powers.

43. Balls, Howat, and Stansbury (2016) propose that a committee chaired by the government takes control of the central bank during a crisis.
Finally, these proposals leave considerable flexibility to the officials that exercise the emergency powers. In both proposals, the decision how to deal with the emergency is not bound by statutes that limit permissible instruments. The exercise of emergency power is also undivided in that, in the proposal for legislative power, it is either entirely up to the EU legislature or, in the case of legislative approval, up to the ECB to decide how to deal with an emergency. These proposals thus have the potential to adequately deal with Schmittian objections. This is not to rule out circumstances in which the very existence of checks and balances leads to gridlock in the political system. Still, the discretion available to political agents must in principle be adequate to deal with the emergency. In this regard, the power of the executive has not been reduced.

I conclude that extending the role of the European legislature in the emergency powers procedure is the most promising way to ensure democratic legitimacy and non-arbitrary exercise of power. It also secures the flexibility needed for adequately dealing with a financial state of emergency.

4. CONCLUSION

In times of emergency, its mandate gives the ECB powers to do, quite literally, whatever it takes. The disclaimer that the ECB will act within its mandate has limited weight as almost any measure that addresses a financial crisis can be construed as falling within that mandate. I have argued that the exercise of these emergency powers currently lack an adequate democratic mandate. The status quo also allows for an arbitrary use of emergency powers in that the legal framework allows the ECB to act pretty much as it sees fit. Crucial checks and balances are absent. To address the objections that I have raised, a future revision of the European treaties must introduce more extensive legislative checks and balances on the ECB’s emergency powers.44

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44. I would like to thank Will Bateman, Dirk Bezemer, Boudewijn de Bruin, James Dempsey, Rosa Lastra, Marco Meyer, and Tom Sorell for helpful comments on this article.


Democracy and the ECB’s Emergency Powers

The Ethics of Consumer Credit: Balancing Wrongful Inclusion and Wrongful Exclusion

MARCO MEYER

1. INTRODUCTION

Perhaps in an ideal world, banks would grant credit to all creditworthy applicants, and deny credit to all those who would default on their debt. But even the most developed credit systems, such as that in the United States, fall far short of this ideal. On the one hand, banks often give credit to applicants who later default. At the height of the financial crisis, US banks wrote off more than 6 percent of their consumer loan portfolios in a single quarter. US households were more than thirty days in arrears on almost 12 percent of loans by volume. On the other hand, banks deny credit to many applicants who could in fact service it. One-third of US Americans who wanted credit last year did not get credit—either because they were rejected, or because they were discouraged from even applying. But the share of the excluded who could have serviced their debt is difficult to gauge, because estimates hinge on a counter-factual: if they had been granted credit, would these applicants have repaid? In Section 2, I will say more about the magnitude of wrongful inclusion and exclusion. I focus throughout on the US example, which is special in some respects, including the lack of a developed rental market, and some features of its legal system concerning defaults on

1. I am interested in all financial institutions offering credit to consumers. This includes many creditors who do not have bank licenses, including lenders specialized in car loans, student loans, and payday lenders. For brevity, I use the term “banks.”


3. Ibid.
mortgages. Much of my discussion does, however, also apply to other developed countries, such as European countries.

My concern in this paper is normative: How should we think about the ethics of credit inclusion and exclusion? In particular, I focus on the following two questions. First, what are the relative weights of the obligations to avoid mistakes of wrongful inclusion and to avoid mistakes of wrongful exclusion? Second, what are the moral trade-offs involved in regulating banks to meet those obligations?

In Section 3, I argue that banks have obligations to avoid mistakes of wrongful exclusion—denying credit to applicants who could service their credit—as well as obligations to avoid wrongful inclusion—granting credit to applicants who will default. Since these obligations can conflict, their relative weights pose an important ethical question. My view is that each mistake of wrongful exclusion infringes the rights of applicants, but individual mistakes of wrongful inclusion do not. Hence considered in isolation, avoiding a mistake of wrongful exclusion trumps avoiding a mistake of wrongful inclusion. In the aggregate, however, mistakes of wrongful inclusion can also lead to severe rights violations, namely when they threaten the rights of shareholders, bondholders, or depositors, or even threaten financial stability. Hence banks have the dual obligation to provide creditworthy applicants with credit, and to avoid over-borrowing. Meeting this dual obligation is the social purpose of banks concerning consumer credit.

In Section 4, I introduce the problem that banks’ self-interest is at odds with their social purpose. The reason is that it is profitable for banks to allow for more mistakes of wrongful inclusion and wrongful exclusion than they ought. Banks may be tempted to allow mistakes of wrongful inclusion for two reasons. First, borrowers in arrears are the most profitable customers, as they pay hefty surcharges. Second, securitization and the too-big-to-fail problem allow banks to pass on some of the costs of wrongful inclusion to other banks or society at large. Banks are also tempted to allow for mistakes of wrongful exclusion. I draw on some basic portfolio theory to show that banks may fare best if they deny credit to a large group of applicants who they know to be almost entirely creditworthy, as long as they cannot identify the few that might not be.

In Section 5, I present a solution to the problem that banks’ social purpose and their self-interest are misaligned. I argue that financial regulation can steer banks toward their social purpose. However, crafting regulation is not a merely technical exercise. Financial regulators face moral trade-offs, of two kinds. The first is due to the fact that minimizing mistakes of wrongful inclusion leads to an increase in the number of mistakes of wrongful exclusion, and vice versa. Hence, regulators need to decide how to balance mistakes of wrongful inclusion and mistakes of wrongful exclusion. The second kind of trade-off concerns how to allocate the burdens of wrongful exclusion. For instance, regulators have several tools at their disposal to limit the growth of mortgage borrowing, each of which may be sufficient to avoid financial instability. The moral trade-off arises because, depending on which tool regulators choose, different groups of people are excluded from credit. In effect, regulators decide who bears the burden of exclusion from credit on behalf of everyone’s interest in financial stability.
In Section 6, I give an example of this latter kind of regulatory trade-off. In some circumstances, safeguarding financial stability requires slowing down the growth of mortgage credit. Financial regulators have so-called macro-prudential tools at their disposal to steer the growth of mortgage credit. I show that which kind of macro-prudential policy regulators adopt has distributive consequences by determining who is foreseeably wrongfully excluded from credit.

2. THE MAGNITUDE OF MISTAKES OF WRONGFUL INCLUSION AND EXCLUSION

Mistakes of wrongful inclusion and wrongful exclusion are more common than one might think. Very roughly, 5–10 percent of consumer credit granted in developed countries like the United States will either not be repaid at all, or will only be repaid after missed payments from borrowers, an indication that households experience financial stress. Large differences in default rates emerge between types of credit and over time. Consider the quarterly charge-off rate on residential mortgage loans. The charge-off rate concerns the proportion of a bank’s loan portfolio that is “written off” in a given quarter. As Figure 1 shows, at the height of the recent global financial crisis, US banks wrote off as much as 2.7 percent of their residential mortgage portfolios in a single quarter. In 2016, this figure had fallen to a more savory 0.1 percent per quarter.

Figure 1. Charge-off Rates on Consumer Loans for US Banks, 1992–2007. Data Source: Federal Financial Institutions Examination Council (2017). [Colour figure can be viewed at wileyonlinelibrary.com]
For consumer credit excluding mortgages, such as credit card debt, car loans, and student loans, charge-off rates increased to 6.6 percent in the worst quarter of the crisis. Similar to mortgage credit, charge-off rates on consumer loans fell substantially, yet stood still at more than 2 percent per quarter in 2016.

Charge-off rates capture only the most severe cases of wrongful inclusion, because they measure only loans banks have essentially given up on. Many more borrowers struggle to service their credit commitments, but eventually succeed in repaying, and are therefore not included in this statistic. This group is better captured by the delinquency rate, the proportion of the loan portfolio where payments were at least thirty days overdue in any given quarter. At the height of the financial crisis, the delinquency rate on residential mortgages was 11.5 percent. In 2016, the delinquency rate on residential mortgages had fallen, but still stood at 4.2 percent. It is also noteworthy that in 2013, 4.1 percent of US citizens had declared bankruptcy at some point during the last five years.

The magnitude of mistakes of wrongful exclusion is more difficult to gauge, because it involves assessing a counterfactual: Would applicants have repaid had they been granted credit? As an upper estimate, we can consider the magnitude of exclusion from credit, not all of which is wrongful. Forty-eight percent of US citizens wanted some kind of credit in 2016. Two thirds of this group obtained credit, but one third did not get the credit they sought. The main reason consumers did not get credit is that it was denied (63 percent of unsuccessful participants). There is another large group, however, who was discouraged from even applying for credit (37 percent).

Clearly, not all cases of exclusion from credit are cases of wrongful exclusion. But there is ample evidence that many of them are. One way to get around the problem of assessing counterfactuals is to study how entrepreneurs who cannot obtain credit put to use capital injections, for instance through inheritance. If they invest their inheritance into their business and run it successfully, this suggests that they could have done equally well with borrowed money and serviced their credit contract. In the United States, a study found that all else being equal, owning more assets makes switches into self-employment more likely. This result suggests that lack of access to capital stifles entrepreneurial activity. But it does not yet follow from these results that entrepreneurs

5. Delinquent loans are those past due thirty days or more and still accruing interest as well as those in nonaccrual status. They are measured as a percentage of end-of-period loans.
8. Ibid.
10. Studies in other countries support this result. One UK study finds that an inheritance of £10,000 doubles a typical British youth’s likelihood of setting up a business. The authors of the study conducted interviews with potential entrepreneurs, finding that raising capital is their principal problem. Another study showed that a 10 percent rise in the value of housing assets increased the number of start-ups by 5 percent in the United Kingdom.
are wrongfully excluded, because we don’t know whether these businesses succeed. Alternatively, people who become entrepreneurs because they receive an inheritance or additional credit due to raising house prices may squander their capital. Unfortunately, the cited studies do not track the success rates of the businesses. But we have complementary data from the United States that sheds light on how additional capital affects the success rates of businesses. One study shows that if business owners inherit $150,000, the probability that they remain sole proprietors increases significantly. At the same time, the receipts of enterprises that survived five years increase by almost 20 percent.\(^{11}\) Hence an injection of capital increases both the likelihood that businesses survive and their profitability. But it still does not follow that entrepreneurs are wrongfully excluded from credit. Perhaps people who receive large inheritances are better entrepreneurs? In contrast, there is evidence that the wealthy are not the better entrepreneurs.\(^ {12}\) Again using US data, another study concludes that higher survival rates of enterprises run by wealthier people are caused by liquidity constraints on poorer entrepreneurs. Taken together, these studies suggest that a sizable share of entrepreneurs lacking access to credit are wrongfully excluded.

The studies we have considered so far apply to credit for small businesses. Do the observations from these studies carry over to consumer credit? There is evidence of wrongful exclusion in US consumption contexts. One study compares trade-offs that high- and low-income buyers make between initial outlay and operating costs when buying air conditioners.\(^ {13}\) The study finds that high-income buyers pay less for air conditioning in the long run than low-income buyers. The reason is that low-income buyers chose cheaper models with higher operating costs. Taking operating costs into account, low-income buyers pay substantially more for air conditioning, even though they are more price-sensitive. The major reason the study identifies is liquidity constraints. Since low-income buyers manage to meet the substantially higher overall costs of cheap air conditioners, they would also be able to service a consumption credit to buy a more expensive model, with only some of the savings due to lower running costs eaten up by interest payments.

Credit exclusion has also been studied in the US housing market.\(^ {14}\) A third of US families rent rather than own. Renting families are not more geographically mobile than buying families—if anything, the opposite holds. Similar to the air-conditioning case, buying houses in the United States is generally cheaper in the long run. Moreover, in the United States, buying generally opens up opportunities to live in higher quality property and neighborhoods. Why do low-income families rent nevertheless? The study suggests that low-income households often do not have access to mortgage credit. Only 8 percent of renting families would be able to secure a conventional mortgage. Many of

these households must be wrongfully excluded, since (1) renting is usually more expensive in the long run than buying a place of similar quality, and (2) most of these households manage to make regular rent payments.

In sum, there is ample evidence that mistakes of wrongful inclusion and exclusion are made in significant numbers. Roughly, 5–10 percent of borrowers are wrongfully included. Wrongful exclusion is more difficult to quantify. Again very roughly, fewer than one-third and most likely more than just a few percent of people wanting credit (roughly 50 percent of the population in any given year) are wrongfully excluded in the United States.

3. THE OBLIGATIONS OF BANKS CONCERNING WRONGFUL INCLUSION AND EXCLUSION

In this section, I will argue that banks have obligations to provide creditworthy applicants with credit, and to prevent over-borrowing. This view implies that banks have obligations to avoid mistakes of wrongful exclusion and inclusion.

We need to draw two distinctions. First, let’s differentiate between creditworthy applicants and applicants who are not creditworthy. For our purposes, applicants are creditworthy if they are willing and able to service the credit contract they seek to conclude. Second, let’s differentiate between applicants who are granted credit and applicants who are rejected. Combining the cases leads to four cases, as illustrated in Table 1.

I will take it for granted that it is permissible for banks to rightfully include and to rightfully exclude applicants. Some will disagree. For instance, if credit were inherently bad, granting credit even to creditworthy applicants might be impermissible. I will set aside this possibility here. Similarly, I will set aside suggestions that rightful exclusion might be impermissible because banks should lend regardless of whether applicants are creditworthy.15 I am sympathetic to the idea that in market economies based on private property, uncreditworthy applicants have some claim to support in becoming creditworthy. But, as I have argued elsewhere,16 this support should not come in the

15. See for instance Muhammad Yunus’s call for a human right to credit—philosophically discussed by Marek Hudon (2008). Yunus promotes an unconditional right to small amounts of credit. Moreover, Yunus’s justification is based on the alleged ability of credit to alleviate extreme poverty. His argument falls short because access to credit is not an effective means of escaping extreme poverty, as others have shown (Sorell 2015). See also Kimberley Brownlee and Zofia Stemplowska’s proposed right to financial inclusion (2015), which includes a right to being granted credit unconditionally.

form of lower access barriers to credit, and the corresponding duty should fall on the state, not on banks. In sum, I maintain, in line with common sense, that it is permissible for banks to accept borrowers who are creditworthy, and to reject borrowers who are not creditworthy.

I want to focus on the moral status of the two remaining cases, those of wrongful exclusion and of wrongful inclusion. Can banks be faulted for allowing either of these mistakes? Initially, you may be moved by the liberal thought that banks, at least if they are privately operated, should be allowed to run their business as they see fit. If so, they do not have an obligation to service or to reject any applicant, creditworthy or not. In contrast, I will argue that banks have obligations to avoid wrongful inclusion and exclusion. There are different ways to argue for this view. For instance, one might ground such an obligation in the fiduciary duties of banks, or in a general duty of businesses to benefit customers and avoid harm.

My preferred way of arguing for the conclusion that banks have obligations to avoid wrongful exclusion and inclusion appeals to a right to credit, which I have argued for elsewhere. The right to credit includes a claim-right of creditworthy citizens to obtain credit at reasonable rates. To summarize the argument briefly: Private property is inherently exclusionary, because it prohibits everyone else from controlling the things you own, and vice versa. Enforcing property rights requires the coercive power of the state, and exercising the state’s coercive power needs to be legitimized. To render the coercive force of the state legitimate, nonowners need to have sufficient reason to accept a duty to respect others’ property rights. But—and this is the core of the argument—nonowners lack sufficient reason to accept such a duty unless a right to credit mitigates the exclusionary character of private property. The reason is that a private property system that does not acknowledge a right to credit imposes an unnecessary burden on the citizens excluded from credit. Withholding credit from creditworthy citizens limits their economic agency beyond what is required to safeguard the advantages of private property. Hence, capitalist societies, which are based on private property, should recognize a right to credit.

If we recognize that citizens have a right to credit, we need to acknowledge a normative asymmetry between mistakes of wrongful exclusion and inclusion. Cases of wrongful exclusion infringe upon a right of citizens—the right to credit. In contrast, individual mistakes of wrongful inclusion are not similarly serious rights violations. Since rights generally trump lesser normative considerations, one might think that banks should put all their efforts into avoiding mistakes of wrongful exclusion, even if this leads to a large number of mistakes of wrongful inclusion.

But this would be too quick. If the number of mistakes of wrongful inclusion made by a bank reaches a certain threshold, the bank’s economic viability is threatened. Shareholders, bondholders, and depositors have moral claims on the management of the bank to take their interests into account.
Moreover, failing banks, if they are systemically important or interconnected with other banks, threaten financial stability, lead to increased interest rates for creditworthy borrowers, or even to a freeze of credit markets. Since exercising the right to credit requires a functioning credit system, the right to credit implies an indirect right that mistakes of wrongful inclusion be limited. Hence rights are in play regarding both wrongful exclusion and inclusion. But the asymmetry persists: every mistake of wrongful exclusion is a violation of the right to credit. Mistakes of wrongful inclusion only infringe rights of shareholders, bondholders, depositors, and applicants cumulatively.

I have argued that citizens have rights not to be wrongfully excluded, and that wrongful inclusion be limited. But why does the obligation to avoid mistakes of wrongful exclusion and inclusion fall on banks? Recall that my argument for the right to credit stems from the need to justify the enforcement of private property rights by the state. The right to credit partially mitigates the exclusionary character of private property. Hence, ensuring that creditworthy citizens have access to credit is in the first instance the state’s business.

But there is no need for the state to discharge the duty itself. The state needs to ensure that people can exercise their right to credit, but does not need to act as the counterpart in credit transactions itself. As long as private companies provide credit consistent with the right to credit, they may act as counterparts in credit transactions instead. Private hospitals serve a similar function vis-à-vis citizen’s right to health care. By operating in the domain of healthcare, hospitals acquire obligations to provide care consistent with the requirements of citizens’ rights. Hospitals need to meet high standards of quality of care, facilities, and clinical quality, for instance. From a normative perspective, meeting these standards provides hospitals with their “license to operate.” Another way of expressing the thought that a private company has acquired obligations toward its customers is to say that it is required to pursue a social purpose. The social purpose private hospitals are required to pursue is to provide high-quality health care for patients.

The obligation of banks to avoid mistakes of wrongful exclusion and inclusion is similarly grounded. In the first instance, the obligation to provide creditworthy citizens with credit falls on the state. By operating in the domain of consumer finance, banks acquire obligations to operate consistently with citizens’ right to credit. For instance, banks need to meet quality standards in conducting credit assessments and in designing their products. The social purpose that banks are required to pursue in the domain of consumer credit is to avoid mistakes of wrongful exclusion and, derivatively, to avoid mistakes of wrongful inclusion.

Applying this description of banks’ obligations in practice gives rise to interesting challenges. I have said above that applicants are creditworthy if they are able and willing to service the credit contract they seek to conclude. But at the time banks and applicants negotiate a credit contract, it remains

unknown whether applicants are in fact creditworthy. First, an applicant’s ability to repay can be undermined by future calamities. Second, an applicant’s will to repay can be weakened by unforeseen developments, or may have been feigned in the first place. This opens up a gap between the decision of the bank whether or not to grant an applicant credit, which needs to be made ex ante, and the knowledge required to discharge the obligation to avoid mistakes of wrongful inclusion and exclusion, which can only be had ex post. This gap implies that what is required of banks in practice is to exercise care and judgment in assessing an applicants’ creditworthiness, and to act on their best judgment.\textsuperscript{19} As we’ll see in the next section, it is not always in the self-interest of banks to do so.

In sum, I have argued that banks have obligations both to avoid mistakes of wrongful exclusion and inclusion. These obligations can be grounded in the right to credit. On this view, mistakes of wrongful exclusion are rights violations, whereas mistakes of wrongful inclusion infringe rights only in the aggregate, insofar as they undermine the claims of shareholders, bondholders, depositors, or threaten financial stability.

4. THE NEED FOR FINANCIAL REGULATION

It might at first seem that the moral obligations of banks are benignly in sync with their financial self-interest. If so, self-interest should propel banks to keep mistakes of wrongful inclusion and exclusion to the bare minimum. But this is not the case. In Section 2, we saw that mistakes of wrongful exclusion and inclusion are not uncommon. I will argue that the frequency of these mistakes should not come as a surprise, because it is in fact not in the interest of banks to minimize mistakes of wrongful exclusion and inclusion. In this section, we will take a closer look at the economics of wrongful inclusion and exclusion, revealing that banks face temptations to allow both kinds of mistakes. Therefore, we need financial regulation and supervision to steer banks toward their social purpose.

Consider mistakes of wrongful exclusion. It is important to realize that the economic goal of banks is to build up a profitable loan portfolio. Accepting the most creditworthy applicants is not the best strategy to reach this goal. The key insight is that accepting the most creditworthy applicants does not lead to an optimal portfolio.\textsuperscript{20} To see this, consider three applicants: Anne, Bettina, and Caspar. All three apply for a private unsecured loan from CleverBank. CleverBank assesses their creditworthiness as follows: Anne and Bettina will service their loan with a probability of 90 percent, while Caspar will service his loan with a probability of 85 percent. If CleverBank wants to select two out of three applicants, which ones should it accept? If CleverBank were to select the most creditworthy applicants, it would accept Anne and Bettina, and reject Caspar. But CleverBank would maximize its expected profits

\textsuperscript{19} Thomas, Edelman, and Crook (2002).
\textsuperscript{20} Beck and De La Torre (2007).
by diversifying its loan portfolio, rather than by selecting the most creditworthy applicants. And diversification might well require a different decision on the part of the bank.

To see this last point, I will add some simplifying assumptions. Suppose that the risk that an applicant defaults is entirely due to the possibility that they are laid off, and that each applicant will only be laid off if their employer closes down. Against the backdrop of this additional piece of information, we can read the credit assessments by CleverBank as a reflection of the probability that the employers of Anne, Bettina, or Caspar will go out of business. The probability scores suggest that the most likely outcome is that all employers will stay in business, with Caspar’s employer being a bit more likely to go bankrupt than Bettina’s and Anne’s employers.

Now here is the rub: Anne and Bettina work for the same employer, AlphaBeta, a clothing manufacturer, whereas Caspar works for a different employer, Delta, a competing clothing manufacturer. Hence the risks that either of them defaults are not independent. In fact, the risks that Anne and Bettina default are highly correlated: if AlphaBeta goes out of business—and only then—both will default on their loan. Let’s suppose that if either AlphaBeta or Delta goes out of business, the other company is going to survive with certainty. Then the risk that Bettina or Anne default is highly inversely correlated with the risk that Caspar defaults, to the extent that if either Anne or Bettina defaults, Caspar will repay with certainty, and vice versa.

If so, lending to Anne or Bettina and Caspar looks more attractive from the bank’s perspective than lending to Anne and Bettina. The reason is that in the latter case, the bank faces a 10 percent risk of losing the principal on both loans. In contrast, in the former case, the risk that the bank loses the principal on both loans is zero, because at least one of the two borrowers in the portfolio will keep their job with certainty. The example illustrates a general fact about the economic incentives faced by banks. Banks are not concerned about the prospects of an individual loan. Instead, they are concerned about the impact that granting a loan will have on the riskiness of their overall portfolio.

The portfolio perspective explains why, in some cases, banks may refuse to lend to the most creditworthy applicants. An insight about the economics of consumer credit helps give a more complete picture of why banks tend to allow for mistakes of wrongful exclusion. Banks have a strong incentive to be cautious in granting credit. That is because they stand to lose more when they grant credit that is not repaid than they forfeit when they deny credit to someone who is creditworthy. The reason is that banks only stand to gain fixed interest payments, which are usually small compared to the principal sum of money loaned to applicants. To illustrate, suppose that CleverBank receives ten credit applications. Let’s assume that nine out of ten applicants are creditworthy, but that one applicant is not. If the bank cannot identify in advance which of the ten applicants is uncreditworthy, it may well deny credit to all ten applicants, because the interest that the nine
creditworthy applicants can afford may not make up for losing the principal in the tenth case.

In sum, taking a portfolio perspective explains why banks have an incentive not to select the most creditworthy applicants, but instead tend to select applicants that fit best with the bank’s existing loan portfolio. Furthermore, banks are naturally cautious and hence tend to tolerate mistakes of wrongful exclusion, because interest payments are small compared to the principal at stake.

Let’s consider mistakes of wrongful inclusion. Above, I argued that the structure of credit contracts gives banks a strong incentive to err on the side of caution, thereby allowing for mistakes of wrongful exclusion. How, then, can banks at the same time face incentives to allow for mistakes of wrongful inclusion?

Part of the answer is that although banks take a hit if borrowers ultimately fail to repay, they stand to benefit if borrowers are merely late on their payments. If borrowers get into arrears, they incur fees, which are an important source of income for banks. In fact, it is an open secret that banks target borrowers who are likely to miss their payment deadlines in order to benefit from charges.21

There are also two systemic reasons why banks allow for mistakes of wrongful inclusion. Both of these systemic reasons rely on the ability of banks to push some of the default risk onto other parties. The first systemic reason is that the division of labor in the financial system reduces banks’ incentives to avoid mistakes of wrongful inclusion.22 Banks that initially grant loans to applicants, so-called primary lenders, can sell those loans to other financial institutions, passing on the risk of default. The income of primary lenders is largely determined by the volume of credit they grant. Since the risk of default matters little for primary lenders, the incentive to avoid mistakes of wrongful inclusion decreases.

This mechanism became apparent during the global financial crisis of 2007–2008. The crisis was triggered by falling house prices, but falling house prices do not automatically lead to higher default rates. Borrowers have an interest in continuing to pay off their mortgage as long as the value of their property is higher than the value of their mortgage.23 The sensitivity of default rates to falling house prices thus depends on the mortgage volume relative to the value of the house, an indicator we will return to in Section 6. If this so-called loan-to-value ratio stands at 80 percent, house prices can fall 20 percent before borrowers have an incentive to default on their mortgage. Hence, falling house prices lead to defaults only if primary lenders do not require borrowers to contribute sufficient equity. Prior to the financial crisis, it was common in the United States to grant mortgages without requiring borrowers to contribute any equity at all. The readiness of loan originators

to provide households with zero equity mortgages is partly explained by their ability to pass on default risk to other financial institutions.

The second systemic reason is that some banks are too big, or too interconnected, to fail. Banks that are systemically important in one of these two ways can count on government support if they run into financial distress. This prospect weakens banks’ incentive to avoid mistakes of wrongful inclusion, because they can push some of the default risk onto taxpayers.

In sum, there are two main sources of incentives for banks to allow for mistakes of wrongful inclusion. First, risky borrowers, some of whom will turn out not to be creditworthy, increase profits by paying fees for late payments. Second, banks can push some default risk onto other financial institutions and onto taxpayers.

One complication concerning mistakes of wrongful inclusion is worth noting. While banks can make mistakes of wrongful exclusion all by themselves, mistakes of wrongful inclusion require the contribution of applicants willing to take out more credit than they can service. An explanation of why mistakes of wrongful inclusion occur thus needs to account for why borrowers enter credit contracts that they won’t be able to service. Boudewijn de Bruin has argued that, prior to the global financial crisis of 2007–2008, many subprime borrowers in the United States should have known that they did not qualify for a mortgage. This gives rise to a puzzle: Why do borrowers take out credit, even though they have access to good evidence that they won’t be able to repay? I want to suggest two reasons.

The first is that consumer credit is often used by less well-off households as a last resort to meet urgent expenditures. In the United Kingdom, a third of households have no savings at all, and 13 percent have savings under £1,500. This means that the breakdown of a household appliance or an unexpected traffic fine can prompt the need to borrow. In such situations, considerations of creditworthiness may seem less urgent. Rather than declaring bankruptcy, households gamble for redemption, in the hope that future income will enable them to pay off their debt. The second reason why people take out credit they cannot repay is low financial literacy. Studies of financial literacy consistently find that people fail to understand basic financial concepts such as interest rates. Lack of financial literacy can be exploited by financial institutions to sell products to customers that do not benefit them.

I have argued that economic self-interest does not propel banks to minimize mistakes of wrongful exclusion or wrongful inclusion. Thus, if they only act out of self-interest, banks will fail to properly discharge their obligation to provide creditworthy citizens with credit at reasonable interest rates, and to prevent over-borrowing. Financial regulators, however, can steer banks to

24. Ueda and Weder di Mauro (2013); Afonso, Santos, and Traina (2014); Gofman (2014)
fulfill their obligations. Thus, financial regulation and supervision are needed to compel banks to fulfill their social purpose.

5. TWO KINDS OF NORMATIVE TRADE-OFFS IN MINIMIZING MISTAKES OF WRONGFUL INCLUSION AND EXCLUSION

Let’s take stock. I have argued that the social purpose of banks is to grant credit to creditworthy citizens, and to avoid over-borrowing. We have also seen that banks’ economic self-interest is not aligned with their obligations. Hence, financial regulation and supervision are needed to steer banks toward their social purpose. In this section, I discuss the normative decisions regulators and supervisors face when they craft guidelines and legislation. My key point is that the task of regulators and supervisors is not merely technical, but highly enmeshed in normative considerations. In particular, regulators and supervisors need to resolve two kinds of normative trade-offs. The first trade-off concerns striking a balance between mistakes of wrongful exclusion and mistakes of wrongful inclusion. This trade-off comes about because of the uncertainty surrounding individual loan decisions. Once this balance is struck, a second trade-off emerges, concerning which kinds of applicants will foreseeably be wrongfully excluded. Let me discuss these two kinds of trade-off in turn.

The trade-off between avoiding mistakes of wrongful inclusion and avoiding mistakes of wrongful exclusion comes about because of the uncertainty surrounding individual loan decisions. Avoiding either mistakes of wrongful inclusion or wrongful exclusion altogether would lead to a sharp increase in mistakes of the respective other kind. Minimizing the risk of wrongful inclusion would make the number of mistakes of wrongful exclusion shoot up, disregarding applicants’ claims to credit. Minimizing the risk of wrongful exclusion would make the number of mistakes of wrongful inclusion shoot up, threatening the financial viability of banks.

The structure of this trade-off is familiar from criminal sentencing. The two types of mistakes judges can make are to let a guilty person pose as innocent and to unjustly sentence an innocent person. It is often hard to know with certainty whether an accused is guilty. Making sure that no culprit ever goes unpunished would therefore require lowering the bar for sufficient evidence such that many innocent people would be sentenced unjustly. Unfortunately, ensuring that no innocent person is ever wrongly convicted would lead to a very high number of criminals escaping sentencing.

To strike an appropriate balance between mistakes of wrongful exclusion and inclusion, it is crucial to determine the relative strength of the claims of applicants not to be wrongfully excluded and not to be wrongfully included. In criminal sentencing, we have erected high bars for proving guilt, recognizing the right of the accused to due process. We thereby affirm the priority of avoiding wrongful convictions over avoiding undeserved acquittals. On the view presented in Section 3, a similar asymmetry applies in the case of credit
assessments. Mistakes of wrongful exclusion are rights violations, and therefore of first-order normative importance. This implies that banks should be required to meet high standards of accountability for making credit decisions. In practice, this should include granting comprehensive access to data on credit decisions to regulators and nongovernmental organizations so that they can screen for discrimination. Banks should be expected to use state-of-the-art techniques in credit assessment, and to develop mechanisms to ensure that their assessments are apt and fair. While banks should be free to specialize in serving select customer groups, they should jointly monitor whether there are customer groups that are currently unserved, and devise strategies to close these service gaps.

In contrast, mistakes of wrongful inclusion are only impermissible once they reach a certain threshold, beyond which they undermine the claims of shareholders, bondholders, and depositors and threaten to undermine financial stability. Therefore, banks should not be held accountable for individual mistakes of wrongful inclusion. Banks should instead be required to obtain meaningful consent from customers. Meaningful consent requires, of course, actual consent. But meaningful consent also requires more than that. Banks need to satisfy a number of conditions that make the credit contract they enter normatively binding.28

These conditions must be reflected in the products banks offer. For instance, consider so-called zero percent interest credit cards. These credit cards allow users to borrow money interest free for a few months by making payments with their credit card. After this period, interest rates rise sharply. It turns out that a large proportion of users run into spiraling debt once the interest-free period ends. This is because many customers over-borrow in the interest-free period, leading to mistakes of wrongful inclusion. Such patterns of wrongful inclusion should in the very least raise warning flags for banks and regulators, which make for the beginning of an argument to discontinue such products.

As long as the conditions ensuring meaningful consent are met, banks should not be held accountable for individual cases of wrongful inclusion. The reason is that mistakes of wrongful inclusion only lead to rights violations insofar as they undermine financial stability, and a small number of mistakes of wrongful inclusion does not lead to financial instability. However, banks have an obligation to keep the level of mistakes of wrongful inclusion below the threshold that begins to threaten financial stability.

Similar to the case of avoiding mistakes of wrongful exclusion, regulators play an important role in preventing banks from surpassing the permissibility threshold for mistakes of wrongful inclusion. The most important piece of regulation concerns the equity requirements set out by the so-called Basel rules.29 The main rationale for capital requirements is that banks have an

incentive to finance themselves with large amounts of debt relative to equity. This allows banks to run the same operations with a smaller amount of equity, resulting in higher returns for shareholders in good times. Less equity also means that shareholders lose more in bad times. But due to the problem of too-big-to-fail, systemically important banks can expect assistance from the government. Capital requirements call on banks to hold a certain amount of equity relative to the loans they make and other assets. Stricter capital requirements reduce the risk that banks fail, but also compel banks to raise more equity to grant the same amount of loans, which may increase borrowing costs. Hence a normative trade-off arises in balancing higher lending costs against potential risks of financial crises. In sum, the first kind of normative trade-off concerns balancing mistakes of wrongful exclusion and wrongful inclusion.

Another normative trade-off arises once this balance has been struck. This second kind of normative trade-off concerns which group of applicants will be excluded from credit. This trade-off is a direct consequence of the peculiar nature of the obligation of banks to avoid mistakes of wrongful inclusion. Banks are obligated to keep the level of mistakes of wrongful inclusion below the threshold that would threaten bank failure. Because assessments of creditworthiness are uncertain, staying below the threshold foreseeably involves denying credit to applicants who are in fact creditworthy. But different rules and guidelines in conducting credit assessments lead to the wrongful exclusion of different groups of applicants. The trade-off, then, consists in balancing the interests of different groups of applicants.

Let me explain how regulators run into this second kind of trade-off in practice. To simplify, assume that keeping banks below the permissibility threshold of mistakes of wrongful inclusion requires slowing the growth of mortgage credit by 10 percent. Regulators can achieve this goal by imposing rules on banks not to lend to certain kinds of borrowers with heightened default risks. But there is no single best way of identifying borrowers who pose heightened risks. Moreover, whether any borrower will default is to a large part due to the performance of the overall economy. Hence any set of rules that sufficiently slows credit growth to keep banks below the permissibility threshold will drastically reduce the likelihood that the remaining borrowers default.

In sum, whether any borrower is creditworthy depends in large part on the ability of regulators to safeguard financial stability, which in turn requires enforcing rules that wrongfully exclude certain borrowers. My creditworthiness may therefore depend on excluding you from credit, or yours on my being denied credit. In the following section, I will discuss an example of such a trade-off.

30. In addition, the new Basel III rules also introduce a leverage ratio, which is the ratio of equity to nonrisk-weighted assets.

6. A STYLIZED EXAMPLE OF A NORMATIVE TRADE-OFF IN MACRO-PRUDENTIAL REGULATION

In this section, I will illustrate the second kind of normative trade-off introduced above by considering the impact of two different tools to curb mortgage lending on mistakes of wrongful inclusion and wrongful exclusion.32

To safeguard financial stability, regulators seek to keep the overall level of private credit within a safe range. One way of reacting to overheating credit markets is to increase interest rates, because higher interest rates increase borrowing costs and thereby decrease credit growth. The distributive effects of interest rate adjustments have been discussed by political philosophers.33

But adjusting interest rates is a blunt tool to slow credit growth, and it is not always available. In times of recession, central banks may want to keep interest rates low to promote economic recovery. So-called macro-prudential tools promise to curb the growth of credit without undermining economic growth.34 Macro-prudential tools aim to rein in credit growth before it reaches dangerously high levels by constraining the ability of banks to extend loans. Indeed, expansive periods in the credit cycle regularly precede financial crises.35 Mortgage credit is the most important component of private credit, and falling house prices are a common trigger of financial crises. Advocates of macro-prudential tools maintain that they can improve financial stability by curbing credit cycles.36

In Section 4, I have already mentioned one macro-prudential tool, namely caps on loan-to-value (LTV) ratios. Applied to mortgage credit, LTV requirements compel banks to restrict credit for borrowers who cannot contribute sufficient equity. Consider Ike and Sam, who would both like to buy a home in the Washington area. Ike has a higher income than Sam, but lower savings. Hence, Ike is more likely to lose access to credit due to an LTV cap than Sam. For example, an LTV cap of 60 percent would limit credit to $180,000 for a house worth $300,000. If Ike’s savings are below $120,000, and Sam’s are above $120,000, Sam will be able to obtain credit, whereas Ike will not.

Requiring certain debt-to-income (DTI) ratios is another macro-prudential tool. DTI requirements compel banks to restrict credit for borrowers who do not earn sufficient income. They restrict access to credit to borrowers whose disposable income is larger than a certain multiple of their mortgage payments. For example, a DTI cap of 30 percent would exclude borrowers from credit who need to pay more than 30 percent of their yearly income to service their loan. For a yearly gross income of $50,000, this means that the costs of the mortgage must not exceed $1,250 per month. Since Sam has a lower

33. Fontan, Claveau, and Dietsch (2016); Reddy (2007).
Marco Meyer

income than Ike, he is more likely to lose access to a mortgage due to DTI ratios than Ike. Hence LTV and DTI caps exclude different groups of applicants from credit.

Assume that a certain LTV cap is equally beneficial to financial stability as a certain DTI cap. What would be the distributive consequences of imposing caps on LTV or DTI ratios? First, note that if macro-prudential tools are successful in safeguarding financial stability, their success results from reducing the number of mistakes of wrongful inclusion. Second, both instruments are rather blunt, in that they exclude applicants from access to mortgage credit regardless of their specific financial situation. Hence we should expect caps on LTV and DTI caps both to lead to significant numbers of mistakes of wrongful exclusion.

But LTV and DTI caps wrongfully exclude different groups of borrowers from access to mortgage credit, as the cases of Sam and Ike illustrate. Caps on LTV ratios privilege savings-rich applicants like Sam, whereas caps on DTI ratios privilege income-rich borrowers like Ike. There are also subtler differences in the distributive effects of these two macro-prudential tools. For example, a cap on the LTV ratio makes it more difficult for people from economically depressed areas to take job offers in richer areas than a cap on the DTI ratio. The reason is that if someone takes a job in a rich area, their income immediately increases, allowing them to meet DTI caps. In contrast, savings need to be built up over time. Therefore, LTV ratios might hamper social mobility more than DTI ratios.

The precise way in which caps on LTV and DTI ratios are imposed also makes a difference for distributive justice. First, consider a medium LTV cap that is imposed equally on all applicants. Second, consider a somewhat stricter LTV cap to be imposed in 90 percent of cases, and a more lenient LTV cap to be imposed in the remaining 10 percent. Both policies should have similar effects on financial stability. In the second case, the stricter cap on most mortgages would increase resilience to downward pressure on house prices, canceling out the adverse effect on financial stability of the small number of more precarious borrowers. But the first and second versions differ in how they distribute the burdens of limiting the number of mistakes of wrongful inclusion. In the first version, all mistakes of wrongful exclusion fall on the least wealthy applicants. In the second version, some of these less wealthy households can get a mortgage, because mortgage lenders can use their prerogative to grant 10 percent of applicants mortgages even if they do not meet strict LTV caps. This suggests that policies to safeguard financial stability can impose burdens progressively, with better-off borrowers shouldering more of the burden for financial stability than worse-off borrowers.

In sum, the choice of macro-prudential tools influences which borrowers face financial exclusion. Depending on whether LTV or DTI caps are applied, safeguarding financial stability falls either more heavily on savings-rich applicants like Sam or on income-rich applicants like Ike. Moreover, the precise
ways in which macro-prudential tools are implemented matter, too. Rather than a single standard for all borrowers, it is possible to impose differentiated standards that impose progressively stricter rules the better off applicants are.

7. CONCLUSION

I have argued for three main claims. First, banks have obligations to avoid mistakes of wrongful exclusion and inclusion. Banks have an obligation to avoid mistakes of wrongful exclusion grounded in the right to credit, and an obligation to avoid mistakes of wrongful inclusion based on the duty to safeguard financial stability. This dual obligation is, if you will, the social purpose of banks with regard to consumer credit. Second, regulation and supervision are needed to steer banks toward their social purpose. Third, regulators and supervisors face two kinds of normative trade-offs: to strike a balance between mistakes of wrongful exclusion and inclusion, and to determine which borrowers will bear the lion’s share of wrongful exclusion.37

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37. Thanks to Boudewijn de Bruin, Joachim Helfer, Jens van’t Klooster, Kate Vredenburgh, Melissa Fernandez, and participants at the Forum Wirtschaftsphilosophie in March 2017 at the Humboldt University Berlin for written comments and discussions. Thanks as well to Martin O’Neill and Richard Holton for comments on an earlier version of this material.


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Probably for the first time, this issue of Midwest Studies applies the resources of analytic philosophy to high finance. It appears on the 10th anniversary of the Global Financial Crisis and considers both the normative and meta-ethical issues that the crisis raises. Foremost among these is the question of how to allocate responsibility for the harm done. As a test case for theories of individual and collective responsibility, the events of a decade ago are of great philosophical interest. The authors disagree over the kind of theory that fits best, and many different agents—individuals, banks, financial systems, credit-rating agencies, governments, and financial regulators—are discussed. Banks have traditionally been involved in “intermediation”—putting assets of savers to work in productive commercial investment. In the period leading up to the crisis, banks in general and investment banks in particular started to engage in trades of new and exotic financial products and services. In the period after 2008 some of these trades were exposed as highly risky and over-dependent on credit. On the other hand, they were for a time profitable and rewarded with huge bonuses. Bankers appeared greedy and regulation was lax. Crucial financial indices were shown to be rigged. Bail-outs of banks that were “too big to fail” raised questions about the proper role of states in global financial services, and the place, if any, of banks in the Rawlsian basic structure. All of these matters are considered by the contributors. The Introduction to the volume briefly surveys the main events leading to and constituting the crisis.
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