

***Ethics and the Global Financial Crisis: Why Incompetence is Worse Than Greed* by Boudweijn de Bruin. Cambridge: Cambridge University Press, 2015. 228 pp. ISBN: 978-1-107-02891-3**

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When I was approached to write this review, I was both intrigued and intimidated. I am a financial economist by training, not an ethicist. Nonetheless, I have spent a fair amount of time trying to understand the global financial crisis and have examined its causes, the policy responses and longer lasting, if unintended effects, all of which bear on its ethical dimensions. The subtitle of Boudewijn de Bruin's book, "Why Incompetence is Worse than Greed," should pique the reader's interest. In the introductory chapter, the author declares that his aim is to "develop a new view of ethics in finance by bringing together various streams of research, including virtue epistemology and behavioral economics" and "suggest paths for future research on the intersection of behavioral finance, organizational design and epistemic virtue theory" (15) and also "offer input to policymaking" (16). I know something about behavioral economics and was curious to find out whether a new (to me) theoretical approach might enable fresh insights into the crisis and perhaps more importantly, provide policy directions to minimize future crises.

I was not disappointed. The author displays wide-ranging knowledge of—and ability to synthesize—business-related disciplines, such as accountancy, finance, economics, organization theory and psychology, with literature in ethics, epistemology, social theory and public policy. He claims with justification that finance tends to be highly technical, opaque to consumers, riddled with conflicts of interest affecting service providers, and that occasionally this results in a financial crisis, or what economists sometimes call a "Minsky moment," a sudden major collapse of asset values taken as part of the credit or business cycle, named after the economist Hyman Minsky. Minsky stressed, of course, that in these moments of collapse it was often bankers, traders and other financiers that periodically played the role of arsonists, setting the entire economy ablaze (Cassidy, 2008). While not discounting greed as a precipitating factor, the author claims quite persuasively that incompetence played a big role in the recent crisis. Generally, competence rests in the domain of epistemology and ethicists concern themselves with motivation (negligent disregard or greed in this context). The author's contribution is to blend epistemology and ethics and develop a normative theory of epistemic virtue, which is defined as an "acquired character trait motivating and enabling its possessor to gain instrumentally valuable knowledge" (203). In this regard, de Bruin maintains that individual character is not only crucial for the possession of knowledge, but that knowledge is gained only when certain traits of character—such as courage, humility, diligence, generosity, commitment to justice and temperance—are cultivated and exercised.

The book weaves together theoretical chapters with case studies related to the financial crisis, including sub-prime mortgage lending, banks, Ponzi schemes, the

role of credit-rating agencies and professional accountants. de Bruin maintains in chapter five that there are three ways for corporate entities such as financial intermediaries to incorporate epistemic virtue: virtue-to-function matching, organizational support for virtue, and organizational remedies against vice. I found the follow-on case study in chapter six on the celebrated Ponzi scheme perpetrated by Bernie Madoff (not directly related to the financial crisis) to be the most illustrative and sharply drawn as relates to the theory, so I will spend some time discussing de Bruin's treatment of this case.

Bernie Madoff was an established and highly respected figure on Wall Street who ran a successful investment fund. His reputation was garnered as an influential market-maker, chairman of the National Association of Securities Dealers, philanthropist and generally a mover-and-shaker in the elite New York community. His investment fund consistently generated modestly high returns of 10 percent per year with low volatility. This was attractive (and apparently irresistible) to a number of high net worth individuals and feeder funds catering to wealthy individuals. Madoff created a culture of exclusivity by seemingly only accepting funds from select sources.

Rampart Investment, an options trader, wanted to emulate Madoff's investment strategy, which it learnt from a partner firm, was essentially a split-strike conversion strategy. Rampart charged an employee called Harry Markopolos, a financial mathematician, to research and replicate the strategy with historical data. He was unable to do so despite strenuous efforts. He established that it was not possible to achieve the return-risk profile claimed by Madoff's fund and concluded that Madoff was running a massive Ponzi scheme.

de Bruin states that Markopolos is an exemplar of epistemic virtue. He displayed epistemic courage in pursuing his findings, epistemic humility in having his models checked by others, epistemic temperance and justice by not rushing to judgment but being persistent in his efforts to alert regulatory authorities and so on. This is also an example of effective virtue-to-function matching.

In contrast, the same case can be used to showcase epistemic vice. There was nothing particularly challenging about the financial due diligence carried out by Markopolos. Scores of other firms investing in Madoff's fund could have carried out a similar analysis and either chose not to do so or continued to invest anyway. Likewise, regulators were blinded by Madoff's reputation and status and failed to ask hard questions for several years after the discrepancies were flagged.

de Bruin's analysis in chapter seven proves useful in dissecting the role of the credit rating agencies in contributing to the financial crisis. The conventional wisdom is that Moody's, Standard and Poor's and Fitch which have a monopoly on the credit rating business for corporate, government and structured finance bonds, routinely assigned overly optimistic ratings to mortgage-backed securities. Both greed and incompetence were likely at play because, as de Bruin points out, the agencies assigned AAA ratings in some cases without having access to (or seeking) detailed information such as loan-to-value ratios and credit scores on individual loans. Moreover, the fact that issuers, rather than investors, pay for the ratings represents a clear conflict of interest.

Interestingly, in this case the author deviates from the conventional wisdom. He assigns equal if not more blame to the large institutional investors, who relied on the ratings without carrying out their own due diligence and reaches back in history to chastise “those governments that forced investors to outsource credit risk assessment to companies of which the trustworthiness is hard to determine” (182). This latter observation is, as far as I know, an original take on the credit rating phenomenon and I wish de Bruin had explored possible solutions to the problem. For instance, is it feasible to construct a joint epistemic agent (issuer and credit rater) as the author suggests is the case with corporate management and professional accountants in chapter eight?

In earlier chapters, the author makes a case for the need for epistemic virtues at the consumer level. The thrust of policy making in recent years, particularly in the US and UK, has been toward liberalization (privatization and deregulation). This is seemingly motivated by an argument for liberty which expands freedom of choice for customers. An example of this was the innovation of sub-prime lending, which includes products like interest-only mortgages with very low down payments and so on. The author does not take a position on the merits of this political trend but he points out that policy makers need to recognize that freedom of choice for consumers comes with a need to inculcate epistemic virtues such as love of knowledge, temperance, and generosity in sharing information. Otherwise, we potentially end up in the situation of consumers subject to behavioral biases (such as myopia and overconfidence) thereby over extending themselves and becoming vulnerable to a fall in home values and possible bankruptcy. The author seems to take a dim view of regulatory interventions like financial literacy programs and mandatory pre-mortgage advice, citing research indicating ambiguous or negative outcomes. He also looks askance at outsourcing epistemic virtue to financial advisers, who likely suffer from their own biases.

I am conflicted about this. Clearly epistemic virtues are desirable at the individual level, but what is the mechanism by which they can be widely achieved? My sense is that most individuals have constrained cognitive capacity and they are going to expend most of it on getting better at their chosen profession. How is the physician, schoolteacher or plumber going to find the time to educate themselves on the finer points of complicated financial products; indeed, how will they not only acquire but meaningfully use the relevant epistemic virtues?

My view, like that of many, is that deregulation in finance has been a mistake. The finance industry has grown too large and generates too much profit as a share of national income, while actually detracting from social welfare at the margin. Adair Turner, former Chairman of the Financial Services Authority in the UK, with others, has suggested that the scale and complexity of modern finance needs to be rethought (Turner et al, 2010). Several commentators, including Martin Wolf of the *Financial Times*, opine that finance needs to become more like a utility business and should be regulated along those lines. Plain vanilla mortgage, insurance, and investment and retirement products are all that the average consumer needs. Perhaps this is naïve and there is no realistic way to dramatically rein in the finance industry given their political clout and lobbying prowess. On the one hand, regulatory

regimes that promote some degree of epistemic virtue are feasible, as the Consumer Financial Protection Bureau mandated by the Dodd-Frank Act in the US arguably demonstrates; however, on the other hand, other surveys indicate that the post-crisis state of ethics in the financial services industry is not healthy and a lot remains to be done (Tenbrunsel & Thomas, 2015).

de Bruin's book is thought-provoking and well researched. Ethicists will gain a lot from studying, debating and contributing to the interdisciplinary research program on epistemic virtue that he has launched.

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