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Introduction

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In medicine, an illness is diagnosed by reading signs and symptoms. One way for the doctor to gain a higher degree of confidence in the diagnosis is to check whether there is a family history of similar conditions. In addition, the doctor can examine people who live in similar conditions yet who are not ill (if available). Such people can help the doctor assess, through comparison to the patient, whether genetic or behavioural factors are more the cause of the illness.

The process of increasing confidence in the initial diagnosis by looking at healthier parts of a population takes centre stage in this book. Before we examine banks that have weathered the recent storm in the financial markets better than most, in this introduction we offer an initial diagnosis. Over the following pages we will take a look at some of the symptoms, confirm that financial markets actors have a family history of being in the centre of economic crises, and provide select arguments in support of our initial diagnosis. In the end, we will suggest a treatment that would allow for a healthy financial service sector aligned to societal aims and value creation.

Symptoms of disease in the financial services industry

Judging from the front pages of newspapers around the world, there was nothing especially memorable about 9 August 2007. In most of the northern hemisphere, people were enjoying their holidays and the mood was relaxed. On that day, however, the European Central Bank injected 94 billion euros of liquidity into the European banking system. Days before, the US Federal Reserve (Fed) had administered a shot of $100 billion to the American financial market. What had happened?

The aim of both the Fed and the European Central Bank was to assure liquidity in the market as banks curbed lending to each other. Commercial banks had suddenly lost trust in each other's ability to service their loans. This lack of trust was well warranted as market participants either did not understand some of the products on their own balance sheets or understood that, regardless of their highly sophisticated character, they had an ultimately flawed basis: vastly expanded sub-prime mortgage lending in the booming US housing market. Be it for not fully understanding their own products, or by actually understanding that they entirely depended upon the impossibility of an everlasting housing boom, the expectation grew that this bubble was about to burst.

Sub-prime lending describes the lending of credit to borrowers who do not meet 'prime' underwriting guidelines. These are borrowers with an increased level of risk due to, for example, a history of loan delinquency, limited debt experience, or recorded bankruptcy. In addition, borrowers received loans that were beyond their means. Mortgage brokers handed out mortgages knowing that the borrowers might not be able to sustain repayments, based on the idea that future price increases in the housing market would absorb the risk of homeowners' running into trouble. They would enable homeowners to borrow even more money to service the loans they should not have received in the first place or, alternatively, the lender could repossess a valuable asset. As wrong as these practices may seem, they would not have been a major risk for the whole banking sector if sub-prime lending had been limited. In the United States, however, it amounted to about 20 per cent of the nation's mortgage lending and constituted the basis of a wide range of investment products. Alan Greenspan later called this common practice 'predatory lending.'[1]

In the years before 2007, American bankers and politicians alike enjoyed talking about the 'democratization of credit' as credit was given increasingly to everyone, be it through sub-prime mortgage lending or the use of credit cards. This allowed consumers to maintain spending levels that could not have been upheld through their incomes alone and led to an unsustainable negative savings rate in many households. Also, banks invented new mechanisms to make more use of these credit arrangements and bundled poor-quality loans into securities, the so-called mortgage-backed securities (MBS[2]), which were then traded globally. These packages where formed by calculation of the default-risk under conditions of growth. The system worked as long as housing prices were rising and cheap money was made available by the Fed allowing poor-quality borrowers to repay their debt, if not through their own incomes, then through accumulating more debt. This process fostered economic growth from which others like building companies, furniture retailers, and the banks' shareholders benefited. However, as housing prices started to fall, many homeowners found themselves in trouble. In a falling housing market, lenders 'rediscovered' the concept of not lending more than a borrower can repay, and without being able to continue borrowing more money to service previous loans, a lot of sub-prime lenders went into default. This caused a chain reaction.

As a drastically increasing number of lenders were not able to pay their mortgages any longer, the market for MBS collapsed. The problem was not so much that they had become worthless – the properties were still there, after all – but that it had become impossible to assign a value to them. Hence within a very short period of time they had become virtually untradeable. As we have seen earlier, roughly 20 per cent of US mortgage lending was in the sub-prime market. So what happened to the other 80 per cent? The difficulty was that traded securities were backed by a mix of sub-prime and prime mortgages in an attempt to spread the risk. This allowed banks to obtain a prime rating for MBS with a relatively low sub-prime backing, which would in turn allow banks to offer presumably low-risk, high-yield investment opportunities. At the same time, it provided a neat answer to the question of how to make money from all those mortgages that should not have been issued in the first place. Even up to this point, though, the consequences of a downturn in the US property market might not have been as severe. During the earlier housing boom however MBS were continuously repackaged and sold from one bank to another, leading to a situation in which at some point no one knew anymore what was actually in them. Some clearly remained prime MBS; some were clearly junk; but in between there was a large amount of products for which no one was able to promptly provide details on the 'B' (backing) of MBS. They came to rely entirely on the eternal continuation of a housing boom in order to even retain their value. For as long as an overall market moves only up, one does not need to worry so much about the specific parts of that market one is exposed to. The very moment prices fall, though, one becomes very interested in knowing exactly what the exposure is. The inability to provide such details on the spot then brought any trading with MBS to a halt. Given that no one knew which bank was exposed to what degree of risk, all banks were seen as existentially at risk and no bank was willing to provide credit to any other bank. Banks were closing down the interbank lending market, which is vital for a functioning financial services sector. Trust – the lubricant of financial markets – was lost, and in our globally interconnected and interdependent financial markets the crisis spread like a bushfire.

More than 300 mortgage lenders and 20 banks filed for bankruptcy by late 2009, and over $3 trillion had to be depreciated (Lechner, 2009). But not only second-tier firms, those that are not too big to fail, ran into trouble. The crisis cut right through Wall Street, the City of London, and many other financial centres around the world, hitting well-established finance institutions, as some of the most famous examples below demonstrate (Table 1.1):

Soon the financial crisis spread into the real economy as credit dried up. Companies found it more difficult to secure financing, leading to uncertainty over the ability to carry out planned investments and, in many cases, to their deferral or suspension. The consequential effects on the job market led to a rise in unemployment, and those who had a job did not know whether it was at risk. Just as corporate credit dried up, so did retail banking. The unavailability of personal loans, in combination with insecurity over jobs and gloomy media coverage on the economy, led to a sharp decline in consumer spending. Bigger expenditures such as cars were postponed, retail purchases were reduced, and demand for services declined. A classic downward spiral was triggered by the reduced availability of credit, leading governments to conclude that even more money had to be injected into the economy, in part by providing cheap money to banks, hoping it would find its way into the real economy through relaxed lending standards (which had turned very stringent very quickly during the crisis), and in part by directly or indirectly supporting big business through, for example, the bailouts of US automakers or incentive schemes for new car purchases in some European countries. All of these measures had one purpose: the restoration of trust. Trust in banks' ability to repay loans they give each other; trust in businesses' creditworthiness; trust in lenders to adhere to some basic rules when deciding on a credit application; trust in governments' ability to uphold the welfare state and guarantee the safety of personal savings in times of crisis.

The human cost of the financial crisis and its repercussions are as severe as its macroeconomic consequences. Financial institutions such as Lehman Brothers had been considered safe havens for pension fund investments. Their bankruptcy lowered the value of pension funds, which in turn lowered pensions received by the elderly by up to 30 per cent (Lechner, 2009). The wave of real-estate repossessions that was sweeping the United States left many of the most vulnerable homeless; others

Table 1.1 The consequences of the financial crisis for selected banks

Country	Financial institution	Date	Description	Consequences
US	Bear Stearns	March 2008	Acquired by JP Morgan Chase for $1.2bn to avoid insolvency.	Share price fell from $57 (13 March) to $10 (29 May).
	Merrill Lynch	September 2008	Acquired by Bank of America for $50bn.	Ceased to exist as an independent bank.
	Lehman Brothers	September 2008	Filed for bankruptcy.	Largest bankruptcy in U.S. history.
UK	Northern Rock	September 2007	Asks the Bank of England for emergency financial support. Customers queue in order to put their money elsewhere.	• Nationalization • CEO resigned • Taxpayer liability $150 billion • 1300 jobs cut
		February 2008	Nationalization of Northern Rock	
	HBOS	January 2009	Acquired by Lloyds TSB.	To allow the merger and to avoid another Northern Rock, the government waived competition law considerations.
	Bradford & Bingley	September 2008	The bank was partly nationalized; its savings business was sold to Santander.	Value dropped from £3.2 billion in March 2006 to £256 million in September 2008.

were forced to relocate with family members. According to an OECD report (OECD, 2010), in the summer of 2010, unemployment in the OECD countries stood at 17 million people higher than in 2007. In addition to the personal hardship – financial and emotional – it creates, every job lost has added to countries' post-crisis debt burden: not only are governments more indebted through the bailouts and stimulus packages, they face reduced tax revenues and potentially expanded welfare costs. As the secretary-general of the OECD, Angel Gurría, states in the same report, 'Cutting unemployment and fiscal deficits at the same time is a daunting challenge.' As experienced time and again in economic crises, it is the weakest who are hit hardest, and in today's global economy this is true not only within nations but also between nations. The IMF called the global financial crisis a setback in Millennium Development Goals progress (IMF, 2010). UN Secretary-General Ban Ki-Moon saw it necessary to urge wealthy nations to not fall short on pledges made in support of the poorest nations before the crisis (United Nations, 2010), and in many poor countries home-grown-export-led success stories were wiped out as international buyers stopped ordering or cancelled existing orders.

Summing up the societal consequences, HSBC CEO Stephen Green said,[3] 'Banks have clearly done things wrong. Some of the practices did not contribute, by any reasonable standards, to human welfare.' The key insight of the history of the 2008 financial crisis and its consequences is that the financial industry is a lifeline for a modern society. If it fails, we all face serious consequences in our day-to-day lives.

The historic roots of the 2008 financial crisis

As stated in the beginning of this introduction, it often helps solidify a diagnosis to examine whether a medical condition is aligned to a family history of similar health problems. For this book, that means that we may gain some valuable input from taking a brief excursion and highlighting some previous financial market crises,[4] all of which left a deep mark in the real economy and all of which were resolved with substantial efforts from taxpayers bailing out banks. Also in all cases banks were yielding high returns through the very conduct that later was determined to be the root cause of the crisis, while the weakest in society were hit hardest by its effects. So let us take a step back in time.

According to Lehman Brothers, in the 18th century we saw 11 banking crises, during the 19th century there were 18, and in the 20th century there were 33. If we were to think that this represents a trend, as sufficient prominent voices suggest, we had better buckle up and brace ourselves. The 2008 financial crisis may well have been just the beginning of a 21st-century financial crises frenzy. If, however, we are to gain some level of security that this does not represent a trend, we direly need to learn from the current crisis as well as from previous crises. Below we list only a selection from the last 150 years that may offer some lessons to further guide our diagnosis of the ills in our financial system.

1860–1900: Creation of the lender of last resort

Overend, Gurney & Co. acted as a discount bank in London (Elliott, 2006). Its key business was providing money for commercial and retail banks. After one of its founders retired, the bank invested in railways and other industries and significantly reduced the short-term cash holding its operations required. As soon as stock prices went down, the bank was short on liquidity, and because the Bank of England refused a bailout, Overend, Gurney & Co. went into liquidation in 1866. Due to its refinancing role for other banks, its bankruptcy had serious consequences for smaller banks. Unable to refinance themselves, some of those had to cease business, despite being solvent financial institutions. In consequence more than 200 companies and smaller banks went out of business. Walter Bagehot suggested reforming the financial system and institutionalizing the Bank of England as a 'lender of last resort' in order to prevent spillovers from the failure of individual banks. In this way the 'Barings crisis' of the 1890s was addressed. Investments of the Baring Bank in Argentina defaulted and forced the Bank of England to rescue Barings by providing £18 million. The rescue forced the Bank of England to suspend the British Bank Charter Act, which bound the issue of money to the equivalent held in gold.

The major societal learning from this crisis was that the collapse of individual banks could affect other financial institutions and lead to an erosion of trust of the whole banking system. In order to keep trust in the system in times of crisis, the central bank was institutionalized as a lender of last resort. Said differently, from the 1890s onwards, English banks could no longer go bankrupt; they would be bailed out by the state and thus, ultimately, by the taxpayer.

1929: The Wall Street crash

The Wall Street crash in 1929 led to the Great Depression of the 1930s (Galbraith, 1955). Driven by the prospects of new industries such as broadcasting and automobile manufacturing, many middle-class citizens, as well as institutions, invested in shares, expecting to make a fortune. The bubble burst at the end of October 1929, and by 1932 90 per cent of the value of publicly traded companies was lost. Some 11,000 of the 25,000 banks in the United States collapsed in this period. It took 25 years before the Dow Jones industrial average recovered to its 1929 level. As share-ownership was widespread, citizens had to cut spending drastically. By 1932 the US economy had declined by half, and 30 per cent of the workforce was jobless. In March 1933 President Franklin Roosevelt initiated his 'New Deal.' Under the New Deal, the government raised tariffs and introduced extensive regulation of financial markets and the banking sector. Among the most important laws stemming from the New Deal was the Glass-Steagall Act (see below). Also the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC) were set up.

One of the Wall Street crash's major lessons is that excessive speculative investment leads to 'bubbles' in financial markets – a bubble must, at some point, burst. Tighter controls and regulation were set up to avoid such speculative excesses.

1985: The savings and loans crisis

Under the conditions of financial deregulation of the 1980s, US savings and loan institutions (S&L institutions) were allowed to enter into more complex financial transactions. In order to compete with big commercial banks, these S&L institutions engaged in risky business activities, which caused their demise in 1985. The US government created the Resolution Trust Corporation to take over all assets and liabilities, leaving the American taxpayer with a $150 billion bill. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 introduced new regulation in the savings and loan industry; however, it did little to shield the country from the 1990/1 recession that is widely attributed to the aftershocks of the S&L crisis. In total the S&L crisis cost $153 billion, of which US taxpayers paid $124 billion and the financial services industry paid $29 billion.[5]

What we can draw from the S&L crisis is that deregulation is in itself a risky business. Policies providing for financial markets institutions to generate upside opportunities without facing an equivalent downside risk may turn into costly adventures for taxpayers. When backed by a lender of last resort and left to their own devices, financial market actors expose themselves to risks they would otherwise be less likely to.

1987: The electronic trading crisis

The US stock markets fell by 22 per cent on 19 October 1987, and markets in Europe and Japan followed suit. The widespread belief that insider trading and company takeovers on borrowed money dominated the markets, in combination with an economic slowdown of the United States, triggered a sell-off in stocks. This was exacerbated by newly introduced electronic trading systems executing orders automatically. As a consequence, so-called circuit-breakers were installed to limit automated trading, and new laws against insider trading were enacted.

The electronic trading crisis demonstrates that fraudulent behaviour of even a small number of market participants leads to an overall loss of trust. Combined with technology that reduces the capacity for intervention based on human judgment, such loss of trust can generate almost instant systemic impact. To address this, new regulation was set up, and automated systems inserted predetermined breaks to limit the systemic effect.

The general pattern that emerges when we analyze the historical roots of financial crises is that regulation follows crisis after crisis, suggesting that purely regulatory responses are of limited impact (see Table 1.2 for a summary).

Table 1.2 The continuous loop of crisis and regulation

The crisis		**... and the legal consequences**	
1866 and 1890	Collapse of Overend, Gurney & Co. caused the collapse of another 200 companies in the UK. Barings crisis forced the Bank of England to bail out by injecting £18m.	1890	The British Bank Charter Act was suspended to avoid a run on the banks.
1929	Wall Street crash in New York due to massive speculative trade. The institution 'stock exchange' lost public trust.	1933/4	The Securities and Exchange Act establishes a regulatory body governing the stock exchange. Enactment of the Glass-Steagall Act.
1985	S&L crisis	1989	Financial Institutions Reform, Recovery, and Enforcement Act
1987	Electronic trading crisis	1987	NYSE introduced 'circuit-breakers' to avoid herding.
2008	Global financial crisis triggered by the default of sub-prime mortgages in the US	2008	Banks like Fortis, Glitnir, and Bradford & Bingley were partly nationalized. US Emergency Economic Stabilization Act of 2008

Patient diagnosis: the root cause of financial crises lies in opportunistic behaviour of banks and their management

The revision of the 2008 financial crisis and the brief excursion into some of its antecedents over the last 150 years suggests parallels in their root causes that cast doubt over our effectiveness in developing a financial services sector that seeks to assume the role of a facilitator to the real economy. What persists is opportunistic behaviour, and such behaviour manifests itself in predominantly three forms: (1) increasing profitability by promoting the illusion that one can make money from money, engaging investors in risky business; (2) establishing executive compensation schemes that incentivize opportunistic behaviour; and (3) lobbying for lax regulation based on the argument that tighter regulation leads to a reduction in competitiveness of financial services firms. Over the following pages we will take a look at what opportunistic behaviour entails before we review a selection of the behavioural patterns in which it manifests itself.

Opportunism describes conscious behaviour that takes selfish advantage of circumstances while showing little regard for principles, values, and norms. In an admittedly simplified summation, opportunistic behaviour of banks aims at the privatization of profits and the socialization of losses.

Seizing opportunities to gain financial advantages goes along with abandoning certain principles which were previously espoused. Because of the abandonment of principles inherent to it, the term ‘opportunism’ is often used pejoratively. Opportunistic behaviour is *unprincipled*: it chooses the means applied to achieve an end based purely on the efficiency and effectiveness in which they are expected to lead to the desired end; often in full awareness of negative consequences that one could not rationally justify; and with great disregard for the rights of those who lack the power to enforce their rights. Opportunistic behaviour acts on the one ‘principle’ that might is right, it brushes aside questions of legitimacy and chooses from all options that can be chosen given by the agent’s power, the *opportunity*, to actually exercise them.

The financial crises ever so clearly demonstrate that we need financial institutions to work in service of the real economy and society at large. When we experience shocks in the financial system, innovations, for example, stemming from investments come to a halt and pensions of people who steadily saved during their working lives are at risk. Financial institutions are a means to an end. However, those market actors sharing responsibility for financial crises use other people's investments and savings for their own purposes, not in service of a greater good but in the pursuit of self-serving goals. They do not act based on the view that they service the people who entrust them with their money and for that service they can charge interest or a fee; they act based on the view that they must maximize their own returns and for that they must pay interest or a fee to those who entrusted them with their money. In short, rather than seeing themselves as service providers to the real economy, they see the real economy as the money supplier to them. In contrast, banking with integrity rejects opportunistic behaviour; it stays faithful to some central principles and sees the raison d'être of financial services actors in the provision of services to the real economy in order to generate societal benefit.

Profitability and the illusion of making money from money

Any diagnosis starts with checking the basics. We need not worry about a patient's occasional headache when we see vital functions are not in order. So let us take a look at the very basics of our financial system, admittedly in a simplified manner, but at times it helps to take the bird's-eye perspective to gain orientation.

Money is defined as a *means of exchange*. The reason we like money so much is that it is a whole lot easier to carry around a piece of paper than, say, a bag full of tradable goods. And what if I wanted to have something that someone else wants to trade, but I have nothing in my bag he or she wants in exchange for what I have to offer? Money does the trick; it allows us to exchange anything we have too much of for anything we want more of, as long as we can offer things of equivalent value to the things we want. This can, however, only work if we do not begin to print more money than the total value of goods and services we produce. On occasion, however, I may need more money than what my surplus tradable goods or services are worth, and then I may want to borrow money from someone who has more of it than he or she currently needs. That's where banks come into play, as they allow me to go to one place where all people who have excess capital deposit their money. The bank will then want to know what I intend to do with the money, and if they believe that I will be able to pay back the initial loan and a little extra to reward the lender for the risks entered into and the bank for the service provided, I will be able to borrow. The person who entrusts excess capital to the bank will need the confidence, though, that the banker will actually take a good look at what my intentions are with the money I borrow. The guiding principle for bankers ought to be to find investment opportunities that are promising a risk-reward ratio determined by the interests of the excess capital holder and not by the interests of the banker.

Banks are only holding other peoples' money in order to reallocate it where someone is short of it, but this shows the potential to generate a surplus in the future. It is not the bank's money that is being loaned, and there is no basis for financial services providers to argue that they should feel entitled to engage in self-serving business against the interest of the depositor. Consequently we must see banks as service providers: they do not themselves produce any goods. But that is exactly what some would like to make us believe. Some banks act as if they 'produce' money from money, but no matter how sophisticated the tools, how eloquent the arguments, or how shiny their financial district offices, this cannot work. We cannot produce additional money without producing additional goods and services of the equivalent value. If we do, we simply increase the nominal value of goods, their price tag, through inflation. Money in itself is worth the value of the paper it is printed on; what counts is the amount of goods and services that exist to back it up: all of that which is exchangeable for that money.

What opportunistic financial market actors want to make us believe, though, is that we can design clever financial products that would indeed allow us to turn a 10-euro note into a 20-euro note *without* also having generated goods and services worth an additional 10 euros. On this very fundamental level, it seems clear that any 'success stories' of 'making' money without also generating some additional value in the real economy needs to be scrutinized and stripped from the smoke-screens geared towards selling this illusion. The first form in which financial market actors' opportunistic behaviour manifests are these attempts to make money from money, and whenever they manage to convince enough people that this would be possible, a bubble is created that, sooner or later, will burst.

Deregulation of the financial industry: Cui Bono?

Opportunistic behaviour misuses demands for deregulation and market liberalization. The aim is not to selectively allow for more market freedom in order to be more effective in servicing the real economy. The aim is to allow for more opportunism; to increase the capacity to choose from a greater variety of options by disposing of burdensome controls and regulations that hinder the execution of some options that may promise high rewards, to financial services actors and not to society. Such opportunities also carry greater risks, which are obviously often ignored knowing that a lender of last resort will step into the breach if and when necessary.

The Glass-Steagall Act, touched upon earlier, was passed in 1932 to fight the effects of the Great Depression. To enhance protection against speculation, the separation of commercial and investment banks was added in 1933 – known as the Banking Act. The act was repealed by US President Bill Clinton in 1999 and allowed for, for example, the merger of Citicorp and Travelers Group to form Citigroup, a company once considered 'too big to fail' (Kaufman, 1990).

The repeal allowed commercial lenders to underwrite in their retail business and trade sub-prime MBS in their investment business. They were as well enabled to use the money from other parts of their business (such as personal savings) for use in gambling by the investment-banking branch. In addition, 'retail banks' frequently held fully owned subsidiaries in the investment-banking arena and actively channelled funds received through retail operations into sophisticated investment products. In good times, these subsidiaries were the stars of retail banks, but as soon as investment banking suffered the effects of the crisis, bankers argued that this business was not really part of their bank, trying to avoid the need to recognize that they had failed their retail customers, that they had acted against the interest of their depositors.

Some observers therefore argue that the repeal of the Glass-Steagall Act is directly responsible for the financial crisis because it did away with one of the most important control mechanisms separating retail and speculative forms of banking. The arguments brought forward by the financial industry to repeal the act are enlightening – demonstrating in whose interest the proposed changes were[6]:

1. Commercial banks are losing market share to other financial institutions outside of the United States which operate in less regulated environments. The act limits the banks' international competitiveness.
2. Trading of MBS is considered a low risk, as they are based on diversification. Therefore, a separation of commercial and investment activities is not necessary.
3. In the rest of the world, the separation is not practiced, and lessons from their regulatory environment can be integrated into self-regulation and national regulation.

These arguments play on the competitiveness of the banks in an international market and in no way make reference to the provision of benefit to society at large. There is reason for doubt, though, over arguments that call tight regulation per se an obstacle to competitiveness. The pharmaceutical industry, for example, can be regarded as highly competitive, yet many of the world market leaders come from countries where very stringent regulation determines the fate of any new products. Pharmaceutical companies from these tightly regulated markets are successful not despite, but because they are facing public counterparts that go to lengths to ensure that a new medication does not pose a public health risk. These measures generate public trust and serve firms as a high quality–low risk seal on their products. However, when it comes to our economic health, we think the best way forward is to adopt a laissez-faire stance on regulation. Would you like to buy some medication in a country where policymakers believe that the best way to ensure pharmaceutical companies do not launch any potentially harmful products is to provide only minimal assistance on the decision of whether or not a product is safe?

Clearly globally consistent regulation of financial services offers, or at least consistency within the main financial centres, is desirable, perhaps even necessary to ensure a level playing field. And it is achievable. The argument that the moment a country tightens the regulatory environment, the whole industry relocates or is put out of business in the rest of the world is hard to follow, especially in a knowledge-intensive industry dependent upon a whole range of first-class infrastructure, such as the financial services sector. The repeal of Glass-Steagall can therefore be considered a significant event of systemic de-learning caused by opportunistic lobbying of the financial industry.

However, money supply, interest rates, and the rules of engagement in financial markets are in the realm of central banks and public regulators; they share responsibility for crises. Regardless of the lobbying pressures they were under, they have failed to realize their mandate when financial market actors are put in a position where they can exercise options that cause harm and hardship to the citizens who depend upon a functioning financial sector.

Alan Greenspan was chairman of the Federal Reserve Bank for more than 18 years and known as a free-market icon.[7] He called the 2007 crisis a 'once-in-a-century credit tsunami.' In a hearing by the SEC, Greenspan's policy was criticized for regulatory mistakes and misjudgements. Greenspan acknowledged that he made a mistake in believing that banks, operating in their own self-interest (opportunism) would protect shareholders and institutions. He said that the financial crisis had 'turned out to be much broader than anything that I could have imagined' and 'I still do not fully understand why it happened.' This realization may be indicative for many people working in the financial industry.

What has happened and what still is happening is that we allow financial market agents to act strictly opportunistically. We somehow maintain a belief that providing a regulative environment that allows for gearing all efforts towards the goal of achieving the highest returns for their own institutions or for their individual benefit will by some magical process automatically lead banks to produce the most desired results for everyone else. The classical neoliberal paradigm, proven time and again to be a dysfunctional basis of orientation regarding the regulation of financial services providers, still governs much of our thinking.

Executive compensation: the systemic effects of incentives based on greed

On the level of the individual bank manager, opportunistic behaviour is encouraged by incentive systems, which are disconnected from the societal consequences of mismanagement. They encourage the deployment of mechanisms whose only purpose is to generate the highest possible short-term returns, giving no consideration to the question of whether these returns add, are neutral to, or extract value from society.

The degree of truth in the claim that financial market actors aim at privatizing profits and socializing losses can be seen most drastically in executive compensation schemes. While banks asked for government bailouts in 2007 and 2008, some managers still claimed their contractually guaranteed bonuses. These claims have led to public outcry, fuelled, for example, by the following cases:

- Despite filing for bankruptcy under Chapter 11, Lehman Brothers' New York staff set aside $2.5 billion in bonuses.[8]
- The Royal Bank of Scotland announced a £28 billion loss on 19 January 2009.[9] Media reports of the bank's intentions to award its executive with nearly £1 billion for this performance prompted an outrage in the United Kingdom.[10]
- United Banks of Switzerland (UBS) announced that it would pay its employees a total of 2.2 billion Swiss francs in bonuses despite reporting a record loss of 19.7 billion Swiss francs.[11]

While these examples demonstrate how far financial executives have distanced themselves from willingly assuming responsibility for their own business decisions, criticism about executive compensation schemes is nothing new. What is new, and an encouraging sign, is that executives now publicly recognize and admit that executive compensation schemes have to change. Duncan Niederhauer, chief executive of NYSE Euronext, said, 'It is quite clear that some of the compensation models at these firms have to be not just incrementally changed but completely overhauled.'[12] Even Stephen Green, chairman of HSBC, realized that there had been a 'huge and growing disparity between levels of income'.[13] A major indicator for judging the adequacy of executive pay is the relation between workers' pay and executives' pay. This measure has been tracked in the United States for over 40 years and demonstrates a widening gap (Figure 1.1).

While top earners in a society have easy access to basic goods as well as good education, excellent lawyers, and private doctors, the bottom 60 per cent are struggling with the necessities of life. In order to finance their daily expenses, they are increasingly forced into debt. Consider the average US credit-card debt per household, which rose from $4301 in 1994 to $15,788 in 2009[15] (by some commentators believed to be the cause for the next crisis). The bottom earners have to take loans in order to buy the car, which takes them to work or to build the house to have shelter for the family. They are also very sensitive to changes in the economic climate, as they are the first to lose their jobs because of their low qualifications. They cannot afford to send their children to 'good' schools, and students from these families need to take loans. The average US college graduate has about $20,000 in debt.[16] The

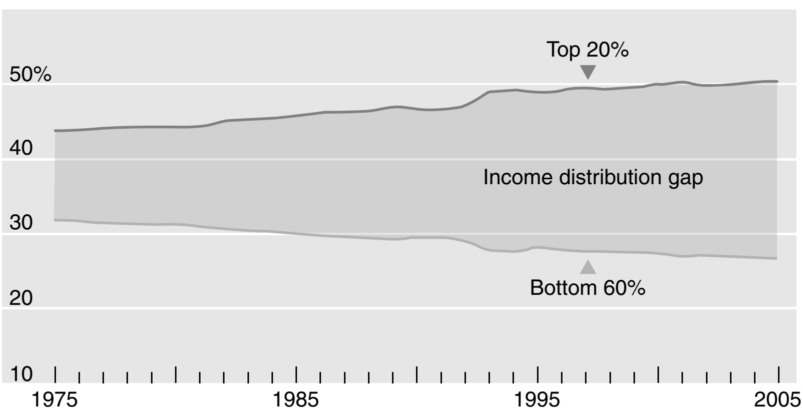

Figure 1.1 The widening income gap[14]

income inequality in the United States can be considered a factor in creating a receptive market for sub-prime mortgages.

Nobel laureate Joseph Stiglitz further holds that executive compensation schemes encouraged irresponsible behaviour. 'Paid by stock options executives have an incentive to increase the market value which is easier by increasing reported income than by increasing true profits, which are bound to real business.'[17] In order to increase reported income, executives aim to get liabilities off the balance sheet or book unearned income. Also, speculation held the potential for quick profits, and successful 'gamblers' were highly rewarded. MBS were another case in point. In these securities, risks were continuously repackaged and sold in an attempt to increase profits without generating any value. The underlying assets in the real economy – real-estate properties, in this case – and perhaps ways to increase their value by improving them were never part of the deal. What was part of the deal was to have an elegant way of getting rid of risks in their own balance sheet by passing them on to someone else after repackaging them in ways aimed at obstructing the buyers' ability to actually understand the inherent risks. This practice satisfied stock-market analysts as well as conditions for bonuses, and, in combination with the awareness of having a lender of last resort ready to step in at times of need, opportunities for personal enrichment were created without having to fear an equivalent risk of personal loss.

Setting aside moral arguments over the question of what ratio between executives' and workers' pay is still justifiable, executive compensation schemes in the financial services sector have generated far-reaching systemic impact. They encourage both the development and the marketing of investment products that are entirely indifferent to any impact they generate other than the resultant return for individuals, all the way from the retail banking client 'advisor' selling pensioners highly risky certificates as the right way to safeguard their life's savings to the trader selling repackaged MBS to other banks or institutional investors. The systemic consequence is that vast amounts of resources and efforts are engaged with financial market activities that are showing no interest in generating societal value, that see the real economy as little more than the necessary money supply for their dealings.

Current incentive systems de-professionalize the banking industry, as they encourage individuals to concentrate on activities with the sole purpose of fostering their own financial benefit. Traditional professions include divinity, medicine, and law. Because of the highly skilled work of professionals, membership in professional bodies comes with prestige and social recognition. Professions are characterized by their specialized knowledge, which require long-term education and qualifications. Their purpose is deeply social, as lawyers defend justice, medical doctors care for health, and priests work for salvation. Professional bodies are autonomous and have a code of ethics in order to discipline members for unprofessional conduct. The most famous of these codes of ethics is the Hippocratic Oath of the medical profession, established in the fourth century BC. It contains the following lines: 'In every house where I come I will enter only for the good of my patients, keeping myself far from all intentional ill-doing and all seduction [...].' As exemplified in this oath, unprofessional conduct refers especially to opportunistic behaviour and in most cases to situations in which professionals enrich themselves through the exploitation of others. This is exactly what current incentives encourage: they are an offer to sell professional integrity. Would you trust a doctor who has a proven track record of showing greater interest in his fees than in your health?

Is our diagnosis correct? can we design a cure?

Our symptom analysis led us to the diagnosis of opportunistic behaviour of banks and their management. If this diagnosis holds, we should expect that banks acting with integrity are less affected by the financial crisis. Analyzing their structures, policies, executive compensation schemes, and behaviours should enable us to derive some useful inoculation against future crises. Therefore, this book takes up the stories of banks which – in our view – are demonstrating an integrity-based approach to banking (see Table 1.3). Thus we wish to deliver a proof of concept that humanistic management is possible – also in the financial sector. For reality proves possibility.

Table 1.3 Cases presented in this book

Bank	**Country**
ABN AMRO Real	Brazil
Banca Popolare Etica	Italy
Banca Prossima	Italy
Branch Banking & Trust	US

Continued

Table 1.3 Continued

Bank	Country
CEI Capital Management LLC	US
Cooperative Bank of Chania	Greece
GLS Bank	Germany
ICICI Bank	India
People's United Bank	US
ShoreBank Corporation	US
Triodos Bank	Netherlands
Wainwright Bank & Trust	US
Investment banks including J.P. Morgan, Banco Santander, and BNP Paribas	US Spain France

Notes

1. 'Greenspan admits "mistake" that helped crisis', Associated Press, 23 Sept. 2008.
2. Often described as collateral mortgage obligations (CMO)
3. ' "Don't demonize banks', urges HSBC chairman Stephen Green', *Telegraph*, 30 Jan. 2009.
4. The information on previous crises was taken from Steve Schifferes, 'Financial Crises – Lessons from History,' BBC News, 3 Sept. 2007, and Jon Henley, 'Show us the money', *Guardian*, 19 Sept. 2007.
5. The figures refer to losses resulting from the S&L crisis between 1986 and 1995 and are taken from Timothy Curry and Lynn Shibut, 'The Cost of the Savings and Loan Crisis: Truth and Consequences', *FDIC Banking Review* 13, no. 2 (Dec. 2000).
6. Taken from the congressional note, available under: http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-9065:1 (accessed 2 Mar. 2009).
7. Information for this paragraph has been taken from 'Greenspan admits "mistake" that helped crisis', Associated Press, 23 Oct. 2008.
8. David Prosser, 'Fury at $2.5bn Bonus for Lehman's New York Staff', *Independent*, 22 Sept. 2008.
9. BBC News: 'RBS shares plunge on record loss', 19 Jan. 2009.
10. David Milliken, '$1.47 Billion Bank Bonus Prompts UK Outrage', Reuters, 8 Feb. 2009.
11. Financial Times Deutschland, Trotz Rekordverlust – UBS verteilt Boni von 2,2 Milliarden, 10 Feb. 2009.
12. Lisa Jucca and Nichola Groom, 'CEOs Say Overhaul of Bank Bonuses on the Cards', Reuters, 30 Jan. 2009.

13. Larry Elliott, 'HSBC Chief Says Widening Pay Gap Contributed to Collapse of Trust in Banks,' *Guardian*, 30 Jan. 2009.
14. Source: U.S. Census Bureau's Current Population Survey, Annual Social and Economic Supplements, 2005.
15. See http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php#footnote1 (accessed 14 July 2010).
16. See Demos.org, 'The Economic State of Young America', May 2008.
17. J. Stiglitz, 'The Financial Crisis of 2007/2008 and Its Macro-Economic Consequences', available online at: http://www2.gsb.columbia.edu/faculty/jstiglitz/download/papers/2008_Financial_Crisis.pdf (accessed 23 Feb. 2009).

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