

The Ethical Roots of the Financial Crisis

LSM

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Or...

- Three cheers for microsocial contracts!

Ethical Roots of the Crisis?

- 1. ~~Wall Street greed~~
- 2. Ethical “tech-shock”
- 3. The “normalization of bad behavior”
- 4. The phenomenon of “pay for peril”
- 5. ~~Hedge fund behavior.~~
 - But hedge funds pose serious ethical problems

Solutions?

Microsocial contracts, especially with *inter-industry norms*:

- Ethical “tech-shock”
- “Pay for peril”
- The “normalization of bad behavior”
- Hedge fund behavior.

Let's back up

What are "microsocial contracts?"

Integrative Social Contract Theory (ISCT):

What general principles, if any, would contractors who are aware of the strongly bounded nature of moral rationality in economic affairs, choose to govern economic morality?

Donaldson, T. and T. Dunfee (1999). Ties that Bind: A Social Contracts Approach to Business Ethics, Harvard University Business School Press.

MACRO SOCIAL CONTRACT

Contracting parties: World level rational contractors

Responding to: Bounded moral rationality and need for moral fabric in business and professional activities

Would agree to A macro social contract with the following terms:

1. **Local communities are to be allowed substantial moral free space to generate obligatory ethical norms for their members through microsocial contracts.**
2. **Norm-generating microsocial contracts must be grounded in consent, buttressed by the rights of voice and exit.**
3. **In order to be obligatory for members of the community, A microsocial contract norm must be compatible with hypernorms.**
4. **Priority rules, compatible with the assumptions and terms of the macro social contract must be employed to resolve conflicts among competing, mutually exclusive microsocial contract norms.**

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HYPERNORMS

- ❑ Local community authentic norms become ethically legitimate, i.e., **microsocial** norms, only when consistent with hypernorms.
- ❑ Hypernorms determine the boundaries of community moral free space.
- ❑ Hypernorms express principles so fundamental to human existence that they should be reflected in a convergence of religious, political and philosophical thought.

Donaldson, T. and T. Dunfee (1999). Ties that Bind: A Social Contracts Approach to Business Ethics, Harvard University Business School Press.

Evidence in support of a principle having hypernorm status:

- 1) A wide-spread consensus that the principle is universal
- 2) Component of well known global industry standards
- 3) Supported by prominent non-governmental organizations such as the International Labor Organization or Transparency International
- 4) Supported by regional government organizations such as the European Community, the OECD, or the Organization of American States
- 5) Consistently referred to as a global ethical standard by international media
- 6) Known to be consistent with precepts of major religions
- 7) Supported by global business organizations such as the International Chamber of Commerce or the Caux Round Table
- 8) Known to be consistent with precepts of major philosophies
- 9) Generally supported by a relevant international community of professionals, e.g. accountants or environmental engineers
- 10) Known to be consistent with findings concerning universal human values
- 11) Supported by the laws of many different countries

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Microsocial contracts

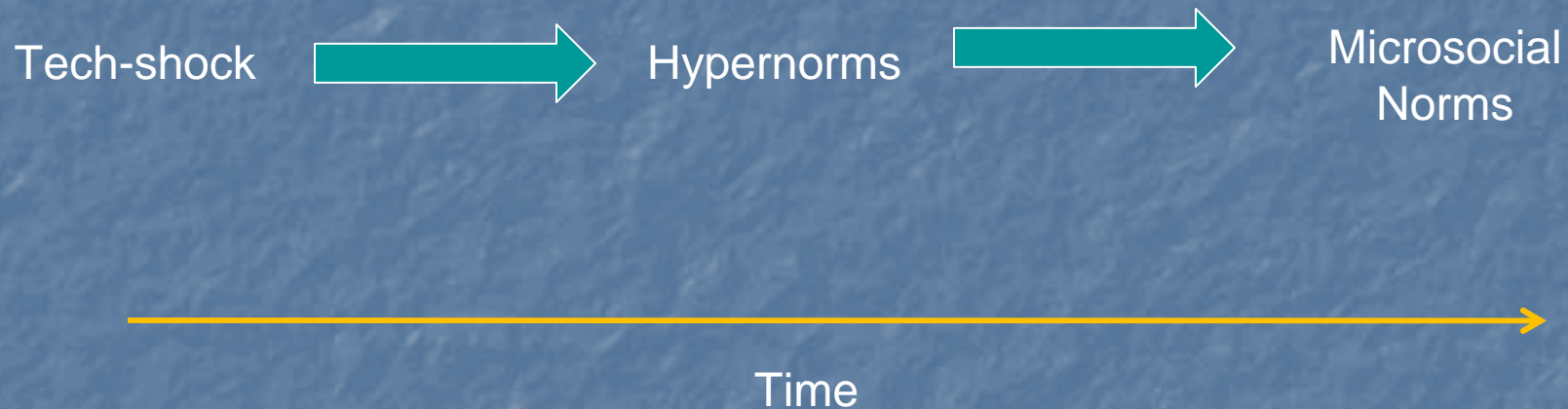
- Microsocial contracts make up the ethical rules of the economic game from the vantage point of communities of players. They represent a general consensus among community members about economic rules and propriety, and may or may not be reflected in black-letter or formal rules. They can be agreed-upon procedures that have grown slowly within an industry or other economic unit to handle a specific problem. (Donaldson and Dunfee Chapters 2-4)

Tech Shock

- Major improvements in the ethical interpretation of economic events can be explained as a transition from the opaqueness of hypernorms to the relative clarity of microsocial contracts.

How evolutionary changes in economic life can be explained by the transition from hypernorms to microsocial contracts.

“Technological” shock on the evolution of ethical norms



Tech-shock: Lessons from medical ethics.

Tech-shock:
Lessons from just war issues.

Tech-shock: Economic life

**Example #1: Highly-leveraged
derivatives:**

Tech-shock: Economic life

**Example #2: Securitization in
the Economic Crisis of 2008**

Pay for peril

The Normalization of Bad Behavior in Industries

Regulatory recalcitrance

- Regulation “lags”:
 - tech shock
 - knowledge inside industry
- Regulatory “capture”
- Finite ability of regulators to monitor firm activity.

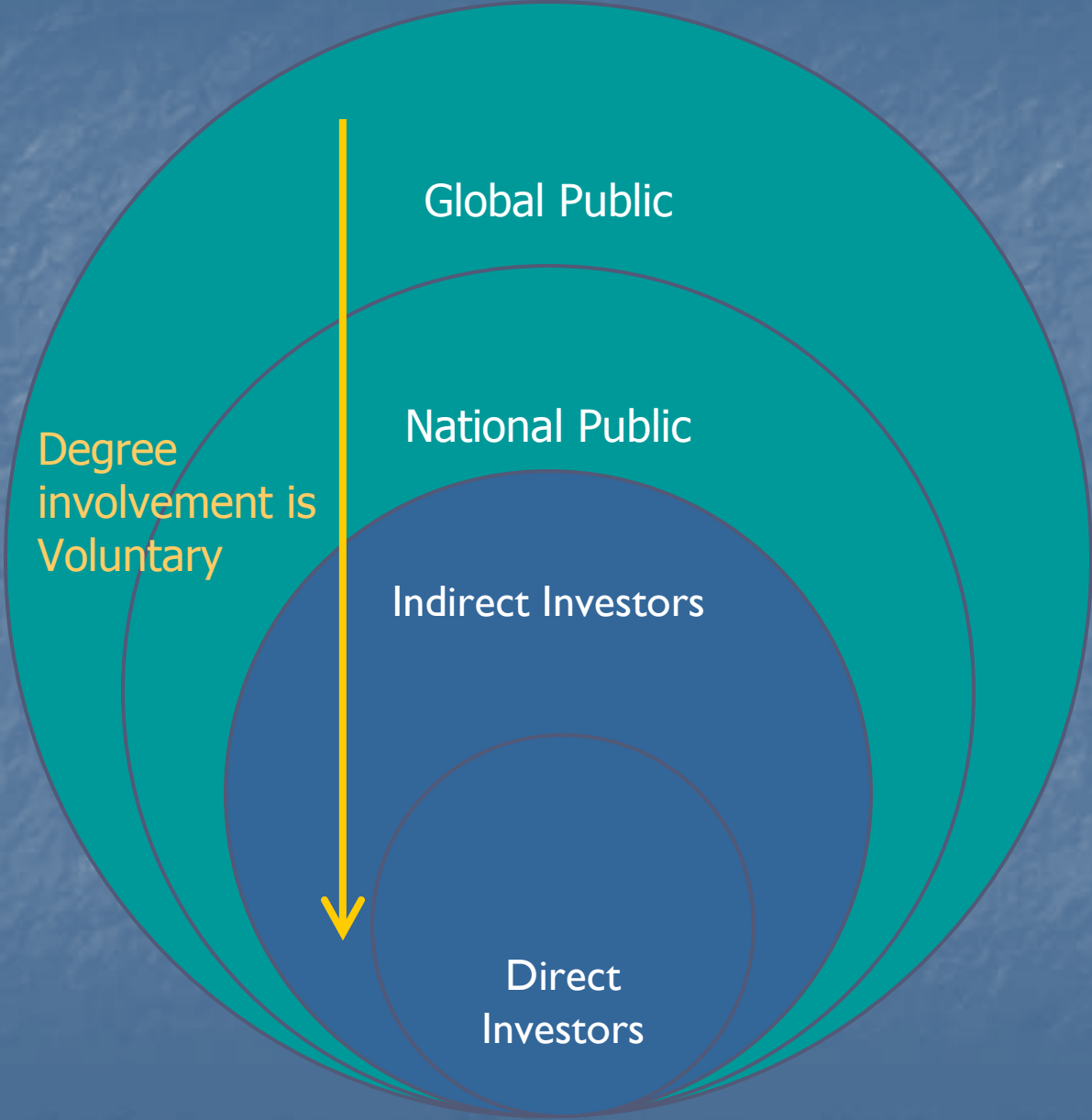
And. . .when microsocial contracts may also address regulatory dilemmas. . .

- Opacity problems with hedge funds

Opacity problems with hedge funds

- Hedge funds are alleged by some to:
 - 1) dupe investors
 - 2) cause social harm

Hedge Funds: Key stakeholder constituencies



Regulating opacity

- Sometimes opacity be regulated away; but with hedge funds it encounters “regulatory recalcitrance.”

Regulatory Recalcitrance with hedge fund opacity problems

- 1. The regulatory process that gathers information and forces disclosure may not only bend entrepreneurial aspirations (as any regulation does) but destroy them.
- 2. The regulatory process that requires monitoring or data collection is either impossible to effect, or impossibly costly.

More promising solution

- Moral coordination, a form of “microsocial contract” instituted as an industry standard, is required relief. In a word, the solution to hedge fund opacity is *ethical*.

Examples of possible Microsocial initiatives:

Financial the Services Industry

- Claw-back policies on executive pay
- Collaborative risk identification
- Distribution of revocable “membership” benefits (e.g., trading on a common platform)
- Transparency rules