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Graafland, J.J.; van de Ven, B.W.

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By Johan J. Graafland, Bert W. van de Ven

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The credit crisis and the moral responsibility of professionals in finance

By Johan J. Graafland
CentER / Tilburg Sustainability Center / European Banking Center
Department of Economics / Department of Philosophy
Tilburg University
P.O. Box 90153
5000 LE Tilburg
The Netherlands
Tel.00 31 13 4662707
E-mail j.j.graafland@uvt.nl

Bert W. van de Ven
Department of Philosophy
Tilburg University
P.O. Box 90153
5000 LE Tilburg
The Netherlands
Tel. 00 31 13 4663091
E-mail b.w.vdven@uvt.nl

Abstract
Starting from MacIntyre's virtue ethics, we investigate several codes of conduct of banks to identify the type of virtues that are needed to realize their mission. Based on this analysis, we define three core virtues: honesty, due care and accuracy. We compare and contrast these codes of conduct with the actual behavior of banks that led to the credit crisis and find that in some cases banks did not behave according to the moral standards they set themselves. However, notwithstanding these moral deficiencies, banks and the professionals working in them cannot be fully blamed for what they did, because the institutional context of the free market economy in which they operated left little room for them to live up to the core values lying at the basis of the codes of conduct. Given the neo-liberal free market system, innovative and risky strategies to enhance profits are considered desirable for the sake of shareholder's interests. A return to the core virtues in the financial sector will therefore only succeed if a renewed sense of responsibility in the sector is supported by institutional changes that allow banks to put their mission into practice.

JEL codes: B31, B59, G01, G21, G31, Z12
Key words: Anglo Saxon capitalism, Banking sector, business principles of banks, credit crisis, external goods, internal goods, MacIntyre, Neo-liberalism

Introduction

According to many commentators, the credit crisis was caused by moral deficiencies on the part of market parties in the financial sector: unrealistic and risky mortgage loans to poor residents (Calomiris, 2008); packaging and selling of these loans in a way that disguised the real risks (Mian and Sufi, 2008); unreliable ratings by specialists (Skreta and Veldkamp, 2009); risky investment policies (of banks) (Posner, 2009), driven by an exorbitant bonus culture of top management (Advisory Committee Future Banks, 2009). In response, politicians have sometimes taken a moralistic stance towards the financial sector, and have suggested that a renewed sense of the importance of ethics is necessary to prevent a future crisis.

This focus on the moral deficiencies of financial professionals and straightforward condemnation of the greed of bankers contrasts with the more general criticism of the neo-liberal free market system. According to the critics of this system, the deregulation movement of financial markets that began in the 1970s is one of the core causes of the crisis, since it forced financial intermediaries to take on more risks. Some politicians and economists have even declared Anglo-Saxon capitalism, or the Neo-Liberal or Wall Street-model as it is also called (Roubini, 2009), essentially bankrupt and propose a shift to a more Keynesian model with more government regulation, with more binding rules on liquidity, capital, leverage, transparency, compensation and so on, in the banking sector (Wolf, 2007; De Larosière Group, 2009; Bebchuk and Spamann, 2010, Krugman, 2008). Part of what went wrong in the credit crisis is thus related to the ideological background of Neo-Liberalism. Neo-liberals believe that the free market is the most important pre-condition for individual liberty, and that the scope of government must be limited to protecting these market freedoms, which are also believed to be instrumental in unleashing the creative powers within society (Hayek, 1960). Related to this is the belief that free markets are self-correcting and should be left to themselves (Gray, 2007, p.120).

In our view, what is needed is a moral evaluation of the conduct of the professionals in the financial sector coupled with an analysis of the systemic causes of the credit crises to arrive at a clear understanding of what can and cannot be expected from an appeal to ethics, and what should be changed in the free market system. These two perspectives are complementary, since the conduct of individuals is strongly influenced by their immediate environment. In the context of the free market, a strong focus on return on investment, shareholder value, and innovative ways to enhance these, are considered desirable. This means that in a certain sense, we (almost) expect traders, bankers, and brokers to be greedy, if not for themselves, then in any case for the people they work for. Since Bernard Mandeville (1714) wrote his famous *The Fable of the Bees,* we have become used to the idea that the vanities and vices[1] of mankind are needed to ensure that enough business will be conducted in society for many to live a prosperous life. Indeed, the exclusive orientation on self-interest of the economic man has become a standard assumption in economics. So from the outset, it does not seem to make much sense to blame agents acting in a business context for trying to serve their own interests. However, the acceptance of the legitimate role of self-interest in a free market society is based on the assumption that this will lead to more prosperity in general. The credit crisis, as we all know, has presented us with a very different picture. Obviously, unrestrained greed can unleash a catastrophe (Tett, 2009).

It is thus far too simplistic to blame the financial crisis and its consequences on the personal vices of the financial professionals involved. Not all of them acted out of selfish motives. As Gilllian Tett has shown in her extensive description of the credit crises, J.P. Morgan’s *Dream team,* who were responsible for the innovative combination of certain pre-existing financial instruments that stood at the basis of Collateralized Debt Obligations (CDOs) out of credit derivatives, were convinced that their innovation, because of the efficiency gains related to shifting risk, would only lead to a better financial world. Quite a few statements by Fed chairman Alan Greenspan testify to the fact that they were not alone in this belief. It is therefore safe to conclude that at least in part the credit crisis found its origin in good intentions and bad outcomes. If we expect that a renewed sense of professional responsibilities will be needed to prevent future crises, we should also reflect on the moral and meta-ethical beliefs with respect to the best organization of the free market that have guided the conduct of market participants in the past.

The purpose of this paper can now be stated as follows. We will try to circumscribe the virtues that professionals working in the financial sector will need to adhere to in order to help prevent future crises, and we will investigate the systemic changes that are needed to provide room for their development. To this end, we will first discuss the main causes of the credit crisis and the major players responsible for it. Next, in section 3, we will perform a normative analysis of the virtues of bankers. To this purpose, we will make use of the ethical theory of MacIntyre on practices and internal goods. Using the official codes of conduct of a number of different banks, we take stock of the goods that are internal to the practice of banking and the virtues that good banking practice requires. In section 4, we contrast these with the actual behavior that led to the credit crisis. Next, we relate the behavior of bankers to the Anglo-Saxon free market ideology and discuss to what extent this ideology allowed room for the development of the professional responsibilities required for sustaining the practice of good banking. Can we expect bankers to become more virtuous if the system in which they have to operate assumes that profit maximization and operating in the service of shareholders are the sole goals of business? Or do we need a complementary systemic change that shifts the focus from shareholder value and free market operation to stakeholder value and more government intervention?

The credit crisis

Although the credit crisis is a complex phenomenon and still needs a lot of scientific research, we can identify a number of main actors and factors that have contributed to it.

Government institutions have failed in three respects. First, the US government can be blamed for implicitly subsidizing the credit expansion in the US housing market through the government sponsored enterprises Fannie Mae and Freddie Mac. Risk managers working at at these banks did not fail to sound the alarm bells, but under political pressure senior management deliberately continued to buy large amounts of Alt-A and subprime loans. The reason was that they wanted to meet certain goals set by the Department of Housing and Urban Development (Calomiris, 2008). By shaping the market for mortgage loans, they encouraged private investors to enter as well. The securitized mortgages were no fixed interest rate mortgages and when interest rates rose, many homeowners were unable to meet the obligations of the bank, as a result of which home prices plumped.

US policy makers also failed in their monetary policy. To sustain economic growth, the Federal Reserve systematically lowered the price of money. The resulting excess liquidity was invested in housing, which led to the housing bubble. A second perverse effect on the financial market of this easy-money policy was that it stimulated the underestimation of the risks attached to defaults of the riskiest parts of CDOs, because the sector knew that if things went wrong the Fed would always come to their rescue by creating enough cheap money to buy them out of their troubles. This at least was what the financial sector had learned from the recent history of monetary policy under Alan Greenspan (Morris, 2008, p. 65).

The third failure concerns the lack of good supervision and regulation of financial markets, both in the US as well as in other countries. This promoted lax underwriting standards to loan originators and led to a failure to correct the market imperfections in the trade of financial products further on in the financial chain and in fact actually encouraged them. First among the believers in the self-correcting power of free markets was Fed chairman Alan Greenspan. At an investment conference in 2003, he defended the free working of the market in derivatives as follows: “Critics of derivatives often raise the specter of the failure of one dealer imposing debilitating losses on its counterparties, including other dealers, yielding a chain of defaults. However, derivative markets participants seem keenly aware of the counterparty credit risks associated with derivatives and take measures to mitigate those risks.” (Morris, 2008, p. 54). As several commentators have observed, super-senior risks attached to CDOs were in the majority of cases not sufficiently recognized by the financial institutions who held them nor by the credit-rating agencies, which used to assign triple-A designations to this part of the CDO structure (Tett, 2009, p. 249). As a result, banks and other financial institutions did not take adequate measures to deal with these risks.

Another major shortcoming in regulation concerns the lack of macro prudential supervision at the multi-country level. Supervision in Europe as well as on the global level focused too much on individual firms, primarily on banks. Observation of significant risks did not result in appropriate action (De Larosière Group, 2009). Due to severe competition with other countries, supervisors feared that tighter supervision would harm their competitive position (Tabellini, 2008). Many national supervisors were unwilling to openly discuss the fragility of their financial institutions. Moreover, there were significant differences in the policies of supervisors.

The second major group of players concerns the commercial banks that sold mortgages to subprime borrowers. In doing so, they failed to check the borrowers’ credit history, their income and other relevant parameters. If house prices declined, subprime borrowers would have less to lose by defaulting on their loans than prime borrowers, because they had made a smaller down payment on the house and had fewer assets and less income to attach in the case of default and recourse. Therefore, the risks involved were higher than for prime borrowers (Jacobs, 2009). The fact that commercial banks continued selling mortgages to subprime borrowers was triggered by the fact that these subprime loans were sold in the secondary loan market within a year after origination. The credit risk was thus passed on to the buyers of these secured mortgages (Mian and Sufi, 2008). As a result, brokers no longer had a long-term relation with their clients and were in fact given an incentive to steer customers towards products that yielded the highest fees, even when much better alternatives for the customers were available. This means that the market for mortgages was plagued by agency problems. It became dangerously naïve to trust your mortgage broker (Morris, 2008, p. 56).

The third major group that contributed to the credit crisis are the investment banks that transformed the mortgages into mortgage-backed securities and collateralized debt obligations. As such, these new innovative instruments to share risk can be beneficial. On the other hand, because of the complexity of the financial products involved, they also create more opportunities for asymmetric information, which can be used to hide risks at the detriment of the buyers of these products. The use of this asymmetric information about the risks attached to financial products presupposes that those responsible at the investment banks did indeed understand the kinds of risks that were attached particularly to mortgage-backed CDOs.

This leads us to the fourth major actor in the crisis, the credit-rating agencies. Competition between rating agencies through rating shopping resulted in rating inflation. Empirical evidence suggests that the more complex the security, the higher the rating bias produced by rating agencies (Skreta and Veldkam, 2009).

The fifth type of players were the buyers of derivatives. They failed to use appropriate risk-assessment models and took too much risk in their portfolios. Their appetite for risk was encouraged by the bonus system, which stimulated a short-term focus on profitability. Given the fact that many investment banks did not take adequate measures to secure themselves against massive defaults, which would also harm the most secure part of the CDO structure, it is likely that many board members did not have a clue of the kind of risks their banks were exposed to.

Finally, as one of the factors behind the strong focus on short-term profitability, the impatience of shareholders of banks needs to be mentioned. The average holding period for stocks until the mid-1960s was about seven years. Today it is less than a year in professionally managed funds (Rappaport, 2005). Aggressive shareholders like hedge funds induced banks to a short-term focus on maximizing stock value.

Professional ethics in finance: an application of MacIntyre’s virtue ethics

In order to evaluate the behavior of professional bankers, we use the virtue theory of MacIntyre. MacIntyre (1985) approaches virtue theory by developing the concepts of ‘practice’ and ‘internal good’. People can only realize the good life if they aspire to the internal goods of the practice they are involved in. MacIntyre defines a practice as any complex form of socially established cooperative human activity through which goods internal to that form of activity are realized in the course of trying to achieve those standards of excellence which are appropriate to that activity. Goods internal to these practices cannot be obtained but by participating in the practice. For example, an internal good of doctors is a good diagnosis. Goods external to the practice are goods that can be obtained independently from the practice, such as prestige among colleagues, financial rewards, job security, and the like. These goods are external because they may be achieved through many alternative ways not related to the practice and are objects of competition. In order to realize the goods internal to a practice, people need to develop virtues. MacIntyre gives the following definition of a virtue: A virtue is an acquired human quality, the possession and exercise of which tends to enable us to achieve those goods that are internal to practices.

In this section, we apply MacIntyre's theory to the practice of banking. To identify the internal goods in the practice of banking and the virtues that financial professionals need to produce them, we do not need to start from scratch. Many of these professionals work for institutions that use codes of ethics or that are organized as professions with their own professional ethics. Our starting point therefore, will be the values and norms that are apparent in the 'mission statements' officially formulated by many banks. These normative frameworks were supposed to guide the behavior of financial professionals. Of course, many of these codes of conduct have been updated to deal with the consequences of the financial crisis, the most important of which are a loss of trust in banks on the part of stakeholders and a loss of trust in the financial sector in general. But this does not mean that new norms and values were developed. In most cases, the code of ethics already mentioned the ethical values discussed below before the crisis unfolded.

The internal goods that the practice of banking aims at can be derived from the mission statements of financial institutions. Table 1 presents the mission statements of a number of banks that belong to the biggest investment banks in the world and that were hit heavily by the crisis. From these mission statements we can derive that the mission of banks is to serve the interests of customers by providing them with relevant financial products at competitive prices. An important internal good that banks claim they want to provide can therefore be defined as offering customers financial products that optimally meet their needs at competitive prices. Some of the mission statements (Goldman Sachs; Deutsche Bank) also explicitly mention service to shareholder interests as a mission. However, shareholder value is not specific to the practice of banking. Hence, we should classify this as an external good to banking.

Obviously, realization of the internal good and the external good are closely linked to each other. As Goldman Sachs states in its first business principle: "Our experience shows that if we serve our clients well, our own success will follow." Also MacIntyre acknowledges that no practice can survive unless it is sustained by institutions and external goods. Moreover, external goods also provide indications of the achievement of internal goods by the practice. Only if business becomes completely focused on external goods, may it fail to support the practice on which it is founded.

Table 1 Mission statements: some examples

Deutsche Bank	We compete to be the leading global provider of financial solutions, creating lasting value for our clients, our shareholders, our people and the communities in which we operate. http://www.db.com/en/content/company/mission_and_brand.htm
Goldman Sachs	1. Our clients' interests always come first. 2. Our goal is to provide superior returns to our shareholders. 3. We constantly strive to anticipate the rapidly changing needs of our clients and to develop new services to meet those needs. http://www2.goldmansachs.com/our-firm/our-people/business-principles.html
ING	ING aims to deliver its financial products and services in the way its customers want them delivered: with exemplary service, convenience and at competitive prices. This is reflected in our mission statement: to set the standard in helping our customers manage their financial future http://www.ing.com/group/showdoc.jsp?docid=074233_EN&menopt=abo
JPMorgan Chase & Co	Our mission is to strengthen communities in which JPMorgan Chase & Co. does business by: Expanding access to capital; Leadership by example; Leveraging the many resources of JPMorgan Chase http://www.jpmorgan.com/pages/jpmc/community/cdg
RABO	The Rabobank Group aspires to help individuals and businesses participate fully and independently in economic activities. Therefore our primary business is provide our customers with all the most modern financial services required for successful participation in today's economy. Wherever we work, and whatever services we provide, we always prioritise the customer, helping them create value and realise their financial ambitions by providing individual financial solutions that are relevant, innovative, and reliable. http://www.rabobank.com/content/about_us/Profile_and_values/mission_statement/
RBS	To deliver superior sustainable value we run our business with integrity and openness, delivering optimum financial results within clearly defined business principles. http://www.csrglobe.com/login/companies/rbs.html
Santander	Santander wants to consolidate itself as a large international financial group, which provides an increasingly high return to its shareholders and meets all the financial needs of its customers. In order to achieve this, it combines a strong presence in local markets with corporate policies and global capacities. The customer is the focus of our strategy. We aspire to continuously increase the number of our customers, their satisfaction and linkage through a wide range of products and services and the best quality of service. http://www.santander.com/csgs/Satellite?accesibilidad=3&canal=CAccionistas&cid=1148925257170&empr=SANCorporativo&idAsset=564100172537840&leng=en_GB&pagename=SANCorporativo/Page/SC_ContenedorGeneral
Société Générale	To help. To finance. To invest. To support. Working by our client's side, across the world. We are committed to furthering their projects, to earning their trust. More than ever, personally accountable and conscious of our responsibilities. We stand by you to safeguard, to act and to anticipate. Strongly optimistic, committed and responsible, thanks to the diversity and skills of the employees of the Société Générale group. http://www.societegenerale.com/sites/default/files/documents/BROCHURE_UK_WEB.pdfthttp://

To realize the internal goods, bankers need several virtues that are considered essential to providing financial services. A review of the codes of conducts shows that the virtue of honesty or integrity in particular (and the related concepts of transparency and openness) is generally perceived to be important for bankers. Deutsche Bank, for example, tells us on its corporate website that integrity and honesty are instrumental in gaining and keeping the trust of its stakeholders. Goldman Sachs also mentions the values of integrity and honesty in their business principles: “Integrity and honesty are at the heart of our business. We expect our people to maintain high ethical standards in everything they do, both in their work for the firm and in their personal lives” (Goldman Sachs, Business principles). ING states: “Our business is based on trust, which is earned by consistently acting in line with our values and principles, irrespective of circumstance or outcome. It also means stakeholders can expect us to keep our promises and act with the highest degree of honesty and fairness.” Similar values are also mentioned in the codes of ethics or business principles of investment banks like JPMorgan Chase & Co and Goldman Sachs: “At JPMorgan Chase, we want to be the best financial services company in the world. Because of our great heritage and excellent platform, we believe this is within our reach. We cannot promise specific outcomes or risk-free results. What we can and will promise is to share the truth, and offer honest assessments of our businesses and our prospects; act with integrity and honor; do the right thing, not necessarily the easy or expedient thing; and work with fierce resolve to make this a company of which our shareholders, employees, customers and communities can be proud” (Excerpt from the business principles of JPMorgan Chase & Co). The RBS mentions integrity and openness in its mission statement. Santander describes its professional ethics as: “Over and beyond strict compliance with laws, codes of conduct and internal regulations, all Santander employees must act honestly and transparently and always put the Group's interests before their own.”, thereby also stressing honesty and transparency.

A second set of virtues that are typical of the banks that we investigated relates to due care for consumer interests. Examples are servitude, responsibility and (long-term) commitment. For example, the RABO bank ensures us that it will create customer value by “providing those financial services considered best and most appropriate by our clients, ensuring the continuity of those services, with a view to the long-term interests of the client and by demonstrating our commitment to our clients and their environment, in ways that help them achieve both their personal, social, and economic ambitions.” Likewise, J.P.Morgan & Co states: “We must act in the customer’s best interest, not once in a while, but consistently. This means offering outstanding products and services and being helpful, courteous and quick to follow up.” Although caring virtues are closely connected to the virtue of honesty, they presuppose a further responsibility of banks towards their clients. Whereas honesty and transparency are obvious moral duties of any contract, they assume that buyer and seller meet each other as equals in an agreement and are equally skilled to evaluate the quality of a product. This assumption is based on classical laissez-faire ideology that stresses “caveat emptor” (let the buyer take care of himself). By contrast, the due care theory argues that sellers and buyers often do not meet as equals and that sellers that are in a more advantaged position have a duty to take special care of the buyer’s interest in the design of the product and the instructions of how to use it (Velasquez, 1998). This is particularly relevant in the case of financial products that typically cover a long period of time (mortgages) and therefore involve complex inter-temporal considerations most ordinary people are not well capable of assessing. This means that a supplier is morally negligent when others are harmed by a product in a way that the supplier could possibly have foreseen or prevented.

A third set of virtues that are often mentioned in the business principles of banks concerns quality or accuracy. The Deutsche Bank states: "As a German global brand, a desire for accuracy, thoroughness and quality runs through our organization. We understand issues in depth. This is why we keep things simple and clear." Goldman Sachs refers to professional quality in its fourth business principle ("We take great pride in the professional quality of our work"). Similarly, J.P.Morgan & Co also refers to commitment to quality in its business principles. In the code of conduct of RABO bank, this virtue is expressed by the concept of professionalism, phrased as "The Rabobank Group provides its customers with high-quality expertise and facilities. It is committed to maintaining high quality - whenever possible anticipating the future needs of customers - and providing its services in an efficient manner." Santander also mentions quality in its business-oriented values (see Table 1). Société Générale links quality to appropriate training and development of their employees: "We need to ensure continual management quality, capitalising on the expertise we possess today in order to maintain it into the future and guarantee our clients the same level of service." The virtues of quality and accuracy can be connected to the phenomenon of risk taking, in the sense that an accurate banker will only deal with products of which he has a thorough understanding of the risks involved. Professional bankers will aim to improve fortune by real skill in trade or profession, and not by excessive risk taking. If they enter into new projects or enterprises, they are likely to be well-concerted and well-prepared. This link between accurateness and risk taking is nicely illustrated by J.P.Morgan & Co's statement that "To build a fortress balance sheet, we must thoroughly understand all our assets and liabilities."

The credit crisis as a test of the moral quality of the practice of banking

In this section, we compare and contrast the moral framework developed in section 3 with the actual behavior of banks as has become apparent during and after the credit crisis. We focus on the three core virtues identified in section 3 and close with some comments on other, related virtues and vices.

Honesty and transparency

Honesty and transparency means that a bank provides information in such a way that the stakeholders involved obtain a good insight into the issues that are relevant for them. In this way, transparent firms contribute to the welfare of their trading parties by allowing them to make optimal decisions with regard to the deployment of their scarce resources that maximize their utility. If banks are not honest or transparent in their dealings, market parties will make sub-optimal choices with respect to the use of their resources. A lack of transparency is especially harmful in the case of asymmetric information. This enables the better-informed market party to exploit the ignorance and trust of the other party by manipulating the price, quality or quantity in a manner that is hard to discern for the less well-informed market party. In section two, we mentioned the information-asymmetry between those who developed the complex financial products and their clients. This information-asymmetry together with the incentive to increase profits creates an agency-problem or the problem of moral hazard (Stiglitz, 2010, p. 14). Commitment to ethical norms and values is one way to deal with this kind of problem, since these values indicate that one should not deceive or mislead the customer, even if it pays to do so.

On the whole, we have hardly found any indications that banks willingly deceived other market parties. A clear example to the contrary is JPMorgan Chase & Co, who explicitly state that they promise to tell the truth, and offer honest assessments of their businesses and prospects. Did they live up to this commitment in the past? According to Gillian Tett it is clear that J.P.Morgan was more alert than many other banks to the risks involved in securitization. She mentions examples of deals that were forsaken if the J.P. Morgan bankers felt that the other party did not really understand the risks involved with complex products like the CDO structure. So it seems that they really had an organizational culture in which integrity, truthfulness and transparency were important values.

On the other hand, there are also examples that indicate that deception and intended lack of transparency did play a role in the credit crisis. Recently, Goldman Sachs was accused by the Australian hedge fund Yield Alpha Fund of Basic Capital of intentionally selling them worthless investment products, as a result of which they went bankrupt. This fund lost $ 56 million with the investment in CDO (collateral debt obligation), which Goldman Sachs sold to shift the risks of these bad investments from their own balance sheet towards others. According to Lewis, the lawyer of Yield Alpha Fund, internal e-mails of Goldman Sachs show that they sold these financial products when they were convinced that they would become worthless. They intentionally sold these products to small market parties, because large banks already knew that they were unsellable.

Goldman Sachs has also been accused of selling similar products to the German IKB Bank and the Dutch ABN-AMRO bank. In these cases, Goldman Sachs is said to have kept silent the fact that these products were constructed by investor John Paulsen, who had selected highly risky mortgages the value of which he expected to decline. IKB and ABN-Amro were led to think that the reliable insurer ACA had constructed these funds. The end result of this kind of deception was that John Paulsen made a profit of a billion dollars at the expense of IKB Bank and ABN Amro. Apparently, the Dutch Rabobank were deceived in a similar fashion by American Merill Lynch.[2]

Due care

Notwithstanding these indications that deception has contributed to the credit crisis[3], it does not seem to have been one of the major causes of the crisis. But what about more subtle forms of moral negligence, such as a lack of due care for the interests of customers?

There are indeed several indications that banks and other market parties in the financial chain have disregarded due care for the interests of their clients. An example is that of mortgage brokers and their customers. As long as the housing market was booming, neither lenders nor borrowers cared much about the (possible) risk attached to their mortgage. Even households that could barely pay the initial low teaser loans, with rates of sometimes below 2.5 percent, had refinanced their loans with ease, often doing so to cash in on some of the perceived equity they had earned thanks to the incredible rise in home prices. Lenders also assumed that if borrowers could no longer pay their mortgage payments they could simply sell their property, at a profit naturally, and easily repay their loans.

In general, we can say that there is no evidence to conclude that the brokers who sold the subprime mortgages had bad intentions. Apparently, there was no will to deceive or to benefit from fraudulent behavior. If it is indeed true that the brokers, like many economists, believed that there was no end to the steady increase in house prices, the subprime loans actually made good business sense. At the same time, the fact that brokers tended to steer customers towards products that yielded the highest fees, even when much better alternatives were available (Morris, 2008, p.56), tells us that brokers have betrayed the confidence put in them by their clients. So even without the intention to do so, it is possible to betray the confidence of clients, simply by not living up to the expectations these clients reasonably had of the way brokers would deal with their interests. The relevant virtue here is taking due care of the interests of clients. Brokers should not have sold their clients products that were not in these clients' best interests, and they should have made sure that clients understood the nature and consequences of the contract they engaged in. So something was indeed wrong with the behavior of many brokers, but this was not so much the intention to deceive clients as the lack of due care for their interests.

One explanation for the lack of due care for the interests of borrowers is that the relation between lenders and borrowers had been broken as a result of securitization (Morris, 2008, Stiglitz, 2010). Mortgage brokers sold the risky subprime mortgages to banks who in turn sold them to all sorts of investors. These investors who bought a mortgage-backed security were in effect lending to the home-owner, about whom they knew nothing. They trusted the bank that sold them the products to have checked things out. Actually, the banks did not really have the incentives to check things out. Their incentives were to pass on the securities they created backed by the mortgages, as fast as they could to others (Stiglitz, 2010). Again, our conclusion is not that bankers had the intention to mislead the investors to whom they sold the securities; probably they were convinced that they were just providing in the demand of some investors in high risk, (relatively) high yield securities. In the meanwhile, the mortgage originators provided in the demand for massive amounts of mortgages which turned out to be truly lousy, but for which there was a profitable market in the short run.

Accuracy and expertise

The third set of virtues concerns accuracy and professional quality. To find out whether banks have shown professional quality, the question we need to ask is what the proper role of banks is, if any, in the securitization business. To answer this question we have to look at the two core functions of the banking system that will be needed in any variety of capitalism. According to Stiglitz (2010), these core functions are the provision of 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. This second core function is related to the first, because if a bank makes poor credit assessments, or if it puts too much money into risky ventures that default, it can no longer make good on its promises to return depositors' money. Given these two functions, it is clear that the banks failed to perform them properly. "Instead, they (America's financial markets) created risk, misallocated capital, and encouraged excessive indebtedness while imposing high transaction costs" (Stiglitz, 2010, p.7). The central values of banks mentioned in their codes of conduct did nothing to prevent the financial innovations from going wrong. The assessment of risks had a very low priority, partly because few people understood the risks involved. But as soon as one gets the feeling that one does not understand all the new innovations that are boosting corporate profits, several alarm bells should start ringing. Not understanding the nature of one's business as a banker violates the virtue of accuracy.

In comparison to the other set of core virtues of banks – integrity and due care – lack of professional expertise seems to have been the most important cause of the credit crisis. Still, one can question whether lack of financial accuracy also leaves the virtue of integrity untouched. Because, insofar as top executives of banks did not understand the nature of their business, they indirectly also violated the values and norms with respect to integrity and transparency. How can one be honest and transparent about a product that one does not understand, and about profits that are based on a business model that is not understood either? To put it differently, the value and virtue of integrity presupposes that one is also concerned about the quality of one's beliefs. Accuracy is closely related to integrity (Williams, 2002). According to Williams, accuracy is the central virtue in the pursuit of truth. Accuracy must ensure that what we say is indeed true. Whereas sincerity is a virtue that should make us say what we actually believe, accuracy is about the quality of these beliefs.

Accuracy's status as a moral virtue is also evident when we consider that an accurate person should also weigh the value of additional information against the costs of acquiring it. The cost of gathering information and overcoming external obstacles (lack of good scientific research or lack of consensus among researchers) and internal ones (pride, fear of consequences) to discovering the truth make the attitude toward these obstacles the subject of moral consideration. In the case of the securitization business, there was not only a lack of knowledge of the risks involved, but also a lack of motivation to want to know that the securitization business was creating a bubble of gigantic proportions. As long as the bubble was still growing, many people benefited from inflating it further. No one appreciates the whistleblower who spoils the party. The truth was simply too inconvenient to dissuade those who continued to make huge profits from continuing these lending practices . The ignorance of bankers, therefore, can hardly count as an excuse. On the contrary, they should have tried to learn more about the way their products were designed, and what the inherent risks of these products were.

Other virtues and vices

The three virtues described above – honesty, due care and accuracy – can be considered to be core virtues of banking. But there are other, related virtues that are important in the banking business. These virtues, or rather the corresponding vices resulting from a failure to uphold them, also played a role in the financial crisis.

First, banks have been accused of greed and lack of justice. In order to encourage chief executives to focus on short-term profits, managers received a substantial variable salary. The incentive to maximize (short-term) profit was therefore very strong. In 2009, banks rewarded their employees with an extremely high number of bonuses. According to the Wall Street Journal (of January 15, 2010), the big American banks and insurance companies paid 145 billion dollars in bonuses in 2009. This is 6% more than in 2007, when the outlays on salaries, bonuses, pensions and option programs reached the highest level ever. The problem is not that bankers aimed at raising the bank's profitability and their personal income, but rather that they did so by neglecting their professional responsibility. As a result, the costs of the failures of the financial sector and rescuing of the financial sector were shifted on to the rest of society. Many banks survived the credit crisis thanks (only) to financial help from the government (Stiglitz, 2010). Many people were left with the idea that this was adding insult to injury: cheating people out of their money and subsequently letting them pay to keep you from going bankrupt. This held particularly for those banks that consciously tried to raise profits by deceiving other market parties.

Another vice that has become apparent during the credit crisis and that is very much related to the core virtues described above is recklessness and imprudence. With the failure to understand their own investments, bankers' behavior can appropriately be qualified as reckless. After all, if your main function is to deal adequately with risks, that is in a way that ensures long term profitability, you should know your business and be fully aware of any possible dangers involved. If you do not understand the kind of risks you are dealing with, you are in the gambling business. Taking excessive risks is an example of lack of prudence. As Bebchuk and Spamann (2010) state, it refers to actions whose expected effect on bank value is negative. Also Adam Smith (1759) argues that recklessness stands in opposition to prudence, because security is the first and the principal object of prudence. The prudent man is averse to exposing his fortune to any sort of hazard. The nature of prudence is cautious rather than enterprising. It aims to improve fortune by real skill in trade or profession, and not by excessive risk taking. If the prudent man enters into new projects or enterprises, he is likely to be well-concerted and well-prepared. The credit crisis has shown, however, that banks often did not have sufficient insight into the risks of the complex financial products in which they invested (Bervas, 2006). Aggressive shareholders like hedge funds prompted banks to a short-term focus on maximizing stock value. In order to meet shareholder's expectations, they increased the leverage by using off-balance sheet items and invested in new but risky financial products.

Because they failed in their understanding of the financial innovations they spread throughout the world, they also failed to live up to their responsibility towards society. This responsibility for banks primarily consists in the societal functions mentioned above. Rather than increasing people's risks through obscure mortgages, financial innovations should help ordinary customers to deal better with the risks of homeownership

A final vice that can be identified in the aftermath of the credit crisis is arrogance. Illustrative of this attitude is the statement made by Lloyd Blankfein, the CEO of Goldman Sachs, that banks are doing "God's work." Notwithstanding the vast harm that the financial sector has caused to society, there are not many signs that banks are prepared to cooperate to transform the banking sector into a more crisis-resistant system. The financial sector and their lobbyists resist any substantial regulation coming their way (Jenkins and Tett, 2010). If the observations made above are correct, part of the problem is the unwillingness or inability of the sector to see clearly where they went wrong, and what should be changed in their working ethos to prevent future crises of this magnitude. If it is true what Stiglitz says that the financial sector in the United States just wants to return to the golden (unregulated) days before the crisis, the world is in for another financial and humanitarian catastrophe.

Shortcomings of Anglo Saxon capitalism

On the basis of section 4, one will be inclined to conclude that the credit crisis stems from a lack of moral strength on the part of banks and other financial market parties and the individual professionals working in these sectors. In any case, Mandeville's defending these vices as being functional to public benefits seems to be misplaced.

However, virtues and vices do not arise in a vacuum. While virtues are necessary to resist the corrupting power of institutions, MacIntyre (1985) argues that the virtues are themselves in turn fostered by certain types of social institutions and endangered by others. Indeed, the reason the banks failed to perform their societal functions is that they had no incentives to do so. An appeal to the social responsibility of bankers and other professionals in finance will not be sufficient to change the way they do business if the institutions around them are not changed. A repetition of the credit crunch can only be prevented by changes in the incentive structure of the financial markets, and that is why regulation, and restructuring of the financial markets would appear to be far more important than an appeal to professional ethics.

Illustrative in this respect is the story that Gillian Tett (2009) tells of bankers at J.P. Morgan (before the merger with Chase) who were responsible for the development of the new financial instruments. They were very reluctant to use their innovation for products concocted from mortgages. The bankers at J.P.Morgan were wary of the risks involved in asset-backed securitization based on mortgages, because there was no way to accurately assess the risks attached to mortgages. For this reason, J.P.Morgan eventually did not use the CDO structure for mortgages. But when the CDO-boom developed and other banks were making profits out of this, it became very difficult for J.P.Morgan to continue their conservative policy. Because J.P.Morgan did not benefit enough from the booming CDO market based on mortgages, market pressures had more or less forced them to merge with Chase (which was highly active in the mortgage market). As a result, JPMorgan Chase & Co decided to raise its profile in the repackaging of mortgage debt. Happily for JPMorgan Chase, when the production line for these CDOs was finally ready to be activated, the pace of defaults on risky mortgages started to quicken (Tett, 2009, p.143-44), which made the management of JPMorgan Chase decide to reduce its risks. At the same time, all other banks and investment funds were still hunting for ways to increase their exposure to the subprime market and boost their returns. This is one of the reasons that the crisis has had less of an impact on JPMorgan Chase & Co than it had on other banks like the Citygroup and Lehman Brothers. What this shows is that, notwithstanding their strong commitment to ethical values, JPMorgan Chase & Co eventually also tried to catch up with the others, and if the boom had lasted a year longer, JPMorgan Chase & Co would probably have received a similar kind of financial blow as other investment banks. The lesson we can draw from this case is therefore that given the ideological background of a belief in the free market, and the idea that recessions were a thing of the past, old-school risk management, which reckons with the reality of the business cycle, was very hard to maintain. Looking back we must conclude that banks like J.P. Morgan, with its old-fashioned belief in the virtues of superior risk management, were on the verge of becoming extinct. Old-school risk management makes sense only if you believe that sooner or later there is bound to be an end to the good times, or in other words, that the economy goes through a business cycle. Instead, financial experts had come to believe that the risk-measurement models they were using were so sophisticated that they would remove more uncertainty than ever before (Green 2009). At the heart of this belief was the false assumption that the markets would always be liquid enough to allow any financial instrument to be bought or sold readily.

In order to put the moral failures of banks into the proper perspective, one cannot afford to leave the system out of the equation, in this case the Anglo-Saxon model of capitalism. The hallmark of the Anglo Saxon model is a free market economy with low levels of regulation, taxes and government expenditures. The main role of government is to secure private property rights. Government intervention or regulation is kept at a minimum, because it is believed to be more harmful than beneficial to the economy. Equity markets are the primary source of funding for companies in Anglo-Saxon countries (direct finance). Therefore, the price of the shares is of major importance to management. In order to stimulate directors of companies to act in the interests of shareholders, companies apply reward systems that link the director’s income(s) to parameters related to shareholder’s interests (Hall and Soskice, 2001). This short-term focus on shareholders is also inherent to the Anglo-Saxon type of capitalism. As Rappaport (2005, p. 65) observes: ‘Financial analysts fixate on quarterly earnings at the expense of fundamental research.’ Most investment professionals recognize that discounted cash flow is the appropriate model for valuing equities, but they also believe that estimating distant cash flows is too time-consuming, costly and speculative to be useful. Because they have much less information about a company’s operations and prospects than insiders, they tend to attach substantial weight to reported short-term performance (Rappaport, 2005).

These features were also at the root of the credit crisis. Since the eighties a policy of deregulation was in place, permitting mergers and the creation of large bank holding companies that blended financial products together. This increased the competition among banks (Broaddus, 1998), forcing them to take on more risk in order to survive in an increasingly competitive industry (Posner, 2009). Because of the necessity to focus on shareholder value, financial managers pursued a strategy aimed at short-term profits at the detriment of the interests of the depositors (Adviescommissie Toekomst Banken, 2009). This triggered the use of excessive risk strategies. Banks that tried to fight the dominant position of shareholders lost. This made it extremely difficult for banks to take their own responsibility in focusing on the long term.

Lack of regulation also offered banks the opportunity to provide mortgages to clients with insufficient collateral or financial strength and to pass the credit risk on to other market parties. Some argue that this type of behavior was provoked by US government policy to foster homeownership and would not have occurred if Fannie Mae and Freddie Mac had not bought these types of mortgages. Convincing though it may sound, this argument is incomplete. To make a government policy effective, it needs to be accompanied by carrots and sticks, and in this case these were lacking. The banks jumped into subprime mortgages without any direct incentives from the government. What is more, Freddie Mac and Fannie Mae's mandate was for "conforming loans," loans to the middle class. So it is an exaggeration to say that the overinvestment in commercial real estate was mainly caused by this government policy (Stiglitz, 2010, p. 10).

Another element that is an inherent feature of Anglo-Saxon capitalism is the innovation of new, complex financial products. The free market ideology assumes that economic liberty is essential in order to leave room for the unforeseeable and unpredictable. According to Hayek we have come to appreciate liberty because we have learned to expect from it the opportunity of realizing many of our aims. "It is because every individual knows so little and, in particular, because we rarely know which of us knows best that we trust the independent and competitive efforts of many to induce the emergence of what we shall want when we see it." (Hayek, 1960, p. 27) It is hard to share Hayek's optimism in the aftermath of a crisis that was partly brought about by an innovation gone wrong. One could raise the objection that it was not the innovation per se that caused the trouble, but the way it was misused in bad risk management practices, and by relating it to bad mortgage lending (Tett, 2009, p. 292). True as this may be, it does not take away the need for more regulatory oversight of the use of innovative financial products. There were only a few financial institutions that used appropriate risk models and foresaw the problems with securitized products (Bervas, 2006). Following this line of reasoning, we can blame the free market ideology of Anglo-Saxon capitalism for contributing to the crisis by allowing too complex products that facilitate asymmetric information. In the Keynesian view of the market, the government has the obligation to protect citizens against bounded rationality.

From this analysis, we conclude that 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.

Conclusion

If banks and their individual professionals cannot be blamed entirely for the consequences of their actions as most of them were only following the money as they were supposed to do, a renewed sense of virtues in the financial sector alone will not be sufficient to restore the internal goods in the financial sector. Institutional changes will also be needed to allow banks to put their mission into practice by embracing a long term strategy that puts service to customers in the first place.

Renewing the sense of public responsibility demands additional professionalization of those who work in the financial sector. This will involve a stringent adherence to ethical codes, competence testing and other measures, some of which are being or have already been taken. But first and foremost, the professionals themselves have to become convinced that this is the road they should be taking: to raise transparency in their dealings and treat their trading partners with respect; to not only focus on serving their own interests and those of short-term oriented stockholders, but to also pay due care to the interests of other stakeholders such as trading partners, clients, deposit holders, employees and society at large; to reduce the degree of risk-taking by lowering leverage, to pursue more careful investment policies based on a thorough understanding of the risks of the investment assets, and to return to the core business that matches the bank's expertise; to take up the responsibility to moderate the bonuses of bank managers so that their income (i.e., fixed salary, bonus, stock options and exit rewards) is proportional to the value added to the banks in the long run and reasonable when compared to the income of other bank employees and employees in other sectors of the economy; and to communicate an attitude of willingness to learn from past mistakes and cooperate with other societal parties to improve the practice of banking.

For the same reason, we also need complementary institutional changes away from the Anglo-Saxon free market paradigm to a more nuanced market view that acknowledges the need for regulation where the risks of market imperfections harming overall welfare are simply too high and too persistent. Alongside the necessary changes in bank policies discussed above, complementary changes are needed in government policies. First, governments should reconsider the Anglo-Saxon model of capitalism and stimulate changes in corporate governance that shift the narrow focus on shareholder value to a more balanced long-term focus on stakeholder values. This will provide an environment that encourages honesty and due care for consumer interests.

Governments should also be more aware of the fact that fostering competition does not always serve the goal of societal welfare and may pave the way for perverse effects. On the one hand, research has shown that liberalization of the financial markets may foster economic growth as a result of improvements in the quality of bank lending, because larger banking companies can take advantage of wide branch networks, better diversification and lower costs of monitoring risky loans. Weak banks that survive behind regulatory entry barriers fail once those barriers are dismantled (Jayaratne and Strahan, 1996).[4] But on the other hand, when competition becomes very fierce, banks that follow a long term strategy of responsible risk taking may be at a competitive disadvantage in the short term and be forced by market parties to adjust to increase profitability by more risk taking. Indeed, many empirical studies show that the nature of competition in the stock market induces short-termism. The short-term focus induced by competition can corrode trust by crowding out people's long-term commitments (Graafland, 2010). With low entry/exit barriers, players in the market may change constantly so that information quickly becomes outdated and long-term horizons collapse. In order to reduce excessive risk policies, governments can also raise minimum solvability requirements for banks (putting a maximum to their leverage ratio) and demand that risky assets remain on their balance sheet. In specific circumstances, government may even forbid certain types of transactions to stabilize the financial markets if private parties are unable to handle the risks involved or if their dealings contribute to the building up of destabilizing systemic risks in the economy at large. To increase the quality and accurateness of banks, legal provisions could be established that guarantee the supervisory directors' ability (such as obligatory tests of expertise and experience and, if necessary, further training of existing directors). Furthermore, governments should learn from the mistakes in the regulation policies of the US government and other governments. Housing market regulation should protect homeowners against bounded rationality. Also, the regulation of the financial sector should be improved to prevent negative externalities of banking on other sectors of economy. Various national and multinational committees have put forward proposals in this regard (De Larosière Group, 2009).

Obviously, regulation must not overrule the banks' own responsibility, but rather should aim to enforce it. It is beyond the power of governments to ensure that banks succeed in properly balancing the interests of all stakeholders involved. Nevertheless, as was already stressed by Aristotle, good laws and regulation can substantially contribute to enforce virtuous patterns of behavior (Graafland, 2010).

[1] Mandeville used a limited concept of virtue, in the sense that very common emotions such as envy, pride, and the desire for luxury were morally suspect.

[2] All these accusations still have to be proven in court.

[3] Apart from the notorious cases of deception that went together with the credit crisis when the financial markets started to plump, like the Madoff case. These cases did not cause the credit crisis, but rather were the result of the shortage of credit once the financial markets came to a halt.

[4] Beck, Levine and Levkov (2007) found that the deregulation of banks in the US from the 1970s through the 1990s also reduced income inequality, by raising the income of lower income workers. They found that the most probable explanation for this influence is that branch deregulation reduces the cost of capital, which expands output and raises the relative demand for low-income workers.

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