Ethical Behavior in an Ambiguous Era

Remarks

of

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to

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Members and Guests of the Centre for Ethics and Corporate Policy:

My remarks to you today have been billed as *Ethical Behavior in an Ambiguous Era*. However, given various widely-known events of the past few years, most notably and principally in the U.S., a more apt title might have been *Despicable Behavior in an Era of Conspicuous Greed*.

Before I embark on what I hope is more than merely a tirade against Wall Street in particular, although many of the World's other financial centres are hardly blameless, let me start on a more positive note. I observe what is self-evident, namely, that everyone in this room, by virtue of your very presence here today, believes in, is committed to, and lives by a strong code of ethics, both personal and institutional, a firm belief in corporate social responsibility, and a subscription to some variety of stakeholder capitalism. This is in sharp contrast to a more Milton Friedmanesque version of high-octane, devil-take-the-hindmost capitalism. Despite some of his now widely, though certainly not universally, discredited views, may he rest in peace.

If you will allow me to get personal for a moment, my own views on these matters have been shaped, as have yours, by many influences, including a small but pivotal incident that took place back in medieval times when I was seven or eight years old.

It was my family's habit on most Saturday mornings to do the grocery shopping for the following week. And so, my father and mother and sister and I would pile into our old Buick and drive to our neighbourhood Loblaw's. Yes, there were Loblaw's stores even way back then.

One Saturday, I wandered off a bit from the rest of the family and, for no particular reason, grabbed a small package of Fleischman's Yeast from a lower shelf. Perhaps I was attracted by the shiny tin foil wrapping. Anyway, I stuck it in my pants pocket.

On our drive home, I showed my new acquisition proudly to my father and mother who were not amused by such a callow display of larceny. When we arrived home, my father informed me quite unequivocally about how he and my mother felt about my theft by administering a remedial spanking that I have never quite forgotten.

And so I was made acutely aware at an early age about the clear distinction between acceptable behavior and what is beyond the pale. It was my first and still memorable encounter with the dictates of ethical behavior on a personal level.

But, enough of childish crimes and on to some rather sordid aspects of the world in which we now live. I'm referring to what I have called, in speeches and articles, a rogue variant of the free enterprise system. This is the variant practiced widely, though certainly not only, by our neighbour to the south.

The current global recession, perhaps the worst since the Great Depression – and we're all still holding our breath about whether we're emerging from it – had its origins in the U.S., precipitated largely by the residential real estate debacle there.

Eventually, of course, the entire industrialized world was sucked into the vortex. Today, more than ever, everything is connected to everything else. Some countries have been affected much less or more than others. It is widely acknowledged that Canada has been a paragon of sound economic policy and of circumspect risk-

avoidance. Others, notably the so-called PIIGS countries – Portugal, Iceland, Ireland, Greece and Spain – are facing a potentially lethal combination of excessive deficit spending and consequent public debt. Greece was, as you know, the first to succumb to harsh economic reality but other countries are dangerously close to facing the same fate.

But, as I said, the tinder box that ignited what is rapidly becoming a global problem was a U.S. housing market that ran amok. And the common denominator was a perversion of any reasonable relationship between risk and reward manifested by unprecedented and obscenely ridiculous levels of compensation, primarily on Wall Street, motivated by avarice and greed.

After any debacle, the media and opinion leaders in general like to cast about for villains. Who was to blame? Almost everyone. That is, each of the several players in the residential real estate boom that ended in the massive implosion that surfaced so dramatically in 2007, was blameworthy and tarnished by unrelenting greed.

For perspective, here are two startling measures of the magnitude of the disaster:

1) By March of 2010, 93% of AAA-rated subprime mortgage backed U.S. securities have been downgraded to junk status. And
2) The total losses from U.S. subprime mortgages will reach an almost unbelievable $1.75 trillion dollars. That's twelve zeroes!

Let me briefly name the principal players and the shameful part each played, starting with the U.S. home buyer. Too many people, motivated by either the prospect of living in a house way beyond

their means or by the prospects of a quick sale and a fast buck from a rapidly appreciating market, were lured into foolish decisions often motivated by greed. Although all the intermediaries did their best to aid and abet decisions that should never have been made.

Which brings me to the mortgage originators, principally the U.S. banks. And so we saw liars' loans that encouraged blatant inflation of buyers' incomes and underestimation of their debts. And we had mortgages granted to applicants known as NINJAS: no income, no job, no assets. And mortgages issued with enticingly low interest rates that rose dramatically after a couple of years. And mortgages that required no principal payments, some even without interest payments, for a period of time. And mortgages for 100% or an even higher percent of the value of the property. And more in a moment on how inadequately that value was determined.

Did the banks hold these mortgages? Of course not. That might have caused them to worry more about the risk/reward relationship. Instead, to a very considerable extent, they bundled their issued mortgages into large pools of, say, 10,000 each and then divided them into tranches rated all the way from AAA to junk.

And, if many of the triple-A rated tranches were, in fact, junk and, if many of the junk-rated were, in reality, junk to the third power, the prevailing attitude of the banks was "What? Me worry?" And there was no immediate reason to, since the bulk of the mortgages were quickly sold to unwary buyers. It was the Greater Fool Theory on steroids.

Which brings me to the rating agencies who, as you are probably aware, are being sued in almost every state in the Union for what were badly flawed processes.

To start with, the task of assigning an accurate rating, under serious time pressure, to a rag-tail collection of 10,000 highly individualistic mortgages was beyond the limits of their capabilities. And, as soon as one giant pile was assessed, there were several more to be valued.

And the Big Three rating agencies competed aggressively for the banks' lucrative business. And their compensation varied with how many ratings went out each of their front doors. If, once again, you smell the odour of greed, you're not alone.

The rating agencies began as sober market researchers, selling careful assessments of corporate debt to those considering buying that debt. But they migrated to companies hired by institutions who were selling debt and who were willing to pay well for anything that would give that debt a seal of approval.

Then there's the real estate brokerage business that stands between the home buyer and the mortgage industry. The fact that everyone in it is compensated by how many deals are done minimizes any likelihood that real estate agents or brokers would explore with their clients the foolish financial risks imbedded in the fine print of the subprime mortgage packages on offer.

And then there were the lawmakers in Congress who, back in the Clinton years, pressured and, in some cases, bought by large donations from lobbyists and their clients, repealed the Glass-Steagall Act from the '30s. That Act had wisely separated investment banking from commercial banking. Its repeal set the stage and opened the floodgates for the real estate train wreck that followed. Pardon my mixed metaphor. And this led to financial instruments so incredibly complicated and convoluted that almost no one understood them. Even the current chair of the Federal

Reserve Bank, Ben Bernanke, no slouch in dealing with complexity, has confessed that he didn't fully understand them.

And so the Masters of the Universe created CDOs (or Collaterized Debt Obligations) that they sold indiscriminately to presumably sophisticated buyers. And then the creators of these Byzantine instruments, recognizing the risks inherent in them, created new and even more complex instruments called synthetic CDOs. These allowed the buyer to bet against the original CDOs. In some cases, the creators held such instruments themselves, betting against what they had sold earlier to their own customers.

The conflict of interest is so blatant that it defies description. The greed necessary to build the original jerry-built CDO is nothing compared to the greed that created the subsequent instruments to bet against the original ones. What a deck of cards! What an ignominious collapse of that deck!

And the U.S. Congress did nothing to prevent the ultimate catastrophe. Of course, once it happened and under the glare of intense publicity, Congress scrambled to try to put in place measures to help ensure that it wouldn't happen again.

To say the obvious, governments in general are much better at locking the stable door after the horses are stolen than before. Better late than never, I suppose, since there will always be more horses. But, anticipatory measures are always preferable to reactionary ones. This is, of course, easier said than done. Was it Marshall McLuhan who said that, in the hand of the blind, the one-eyed man is a hallucinated idiot?

What doesn't help is the startling fact that, in Washington, there are 535 members of the two Houses of Congress, while there are some 33,000 registered lobbyists. That's a wild ratio of 62:1.

And while it's a different kind of greed, the greed that motivates very large flows of money from vested interests, through these lobbyists, to help politicians stay in power has been an important cause of avoiding or deferring legislation that's clearly in the public interest. The repeal of Glass-Steagall was the triumph of narrow self-interest, greased by lobbying dollars, over careful risk-assessment and that public interest.

The broad conclusion from this short run through the smouldering ruins of the U.S. residential real estate fiasco is that all parties bear a share of the guilt for what happened. And a common denominator was greed.

Now, before you begin to wonder where I'm going with all of this, let me quantify briefly how greed as a motivator has influenced compensation. Then I'll circle back with some comments on what I think is implied for such essential components of a just society as corporate social responsibility. Let me begin with some longer-run macro-level trends, and then speak briefly to some more current Wall Street numbers.

It is well-known that the relationship between the all-in compensation of the CEO of a Fortune 500 company and that of the lowest-paid employee of that company has been changing in one direction for many decades. In 1960, the multiple was 40 to 1. In 1980, it was 80 to 1. In 2006, it reached 450 to 1, though it appears to have fallen off slightly to 400 to 1 in the less ebullient years that have followed. And for the largest 1000 U.S. public companies, the ratio peaked in 2006 at an astonishing 1000 to 1.

Another long-run statistic is the ratio of all-in CEO compensation to that of his or her most senior direct report. Again focusing on the S&P 500 companies in the U.S., this ratio averaged about 10 to 7 in the 1950s and 1960s and perhaps even a little later. But over the subsequent years, it has increased steadily and perhaps a bit stealthily to about 4 to 1 and sometimes even higher.

So much for the evident reality that large corporations are far too complicated today to be run by a so-called captain of industry or by a celebrity CEO. Instead, these corporations require consummate teamwork and a massive decentralization of responsibilities wired together by sophisticated systems of communication and by intense human interaction.

And yet, too many CEOs, especially in the U.S., but certainly not only there and especially in the vast financial world, are far more consumed by how many dollars they can accumulate personally than by broader concerns. So much for balancing the best interests of the various constituencies involved in an enterprise.

To be blunt about it, too often we are seeing the triumph of narrow self-interest motivated by – and here's that ignoble word again – greed.

Allow me to mention briefly a straw in the wind, but a revealing straw. I studied at Harvard Business School twice, once in the '50s and once in the '70s. In the '50s, by far the most popular second-year elective course offered was called, simply, Manufacturing. It was taught by a former leader of the Free French in WWII, the charismatic General Georges Doriot. Year after year, more students registered to take his course than could be accommodated.

Now scroll forward to the ’70s and to the subsequent years up to the present. Manufacturing per se is no longer on offer. By far the most popular courses are in Finance and its many manifestations. By far the most sought-after career choice for HBS graduates is Wall Street, although its current state of flux is causing some rethinking, even if only temporarily.

Perhaps this migration over several decades from manufacturing to finance, from Main Street to Wall Street should not surprise. Compare the profitability of, say, Goldman Sachs – even as I speak – to that of a U.S. automobile or steel or consumer products company. It’s no contest!

When the best and the brightest, the smartest people in the room, opt for private equity or hedge funds or investment banking in general as fields in which to pursue their careers, they are both the cause and the effect of a profound difference in both corporate profitability and personal earnings between finance and manufacturing.

Let me illustrate these compensation differences with some examples. The new CEO of General Motors, Ed Whitacre, is expected to earn a total of $9 million this year. At General Electric, the only company of the original Dow 30 companies still standing and highly respected for its strong management practices over many decades, the current CEO, Jeff Immelt, earned a total of $5.5 million in 2009. In that same year, Klaus Kleinfeld, Alcoa’s CEO, earned $11.2 million.

None of these personal earnings are to be sneered at, of course, but contrast them with some breathtaking numbers from Wall Street. In 2007, several dozen of its more prominent inmates earned in excess of $100 million. Seven took home more than a billion dollars.

In 2006, the twenty top-paid hedge fund and private equity managers were paid an average of $657 million. Note that I said "were paid," not "earned." At the top of the pile were John Paulson, CEO of Paulson and Company, who made $2 billion, and James Simmons of Renaissance Technologies who topped even that with a round $2.5 billion payoff.

One more straw in the wind and I'm finished with these sorry, sordid examples of greed and excess in full flight. The world's largest bank is the Industrial and Commercial Bank of China. Its CEO, a Mr. Jiang, earned in 2008 the U.S. equivalent of $234,700, all-in.
The fourth-largest bank in the world is JP Morgan Chase. Its CEO, Jamie Dimon, was paid $19.6 million in that same year. That's 84 times what Mr. Jiang was paid.

Go figure. Maybe currency had something to do with it. The yuan may still be undervalued. Or could it be that the U.S. business culture puts executive interests ahead of those of all others?

So much for some unseemly facts. But, more to the point, what do they imply for continuing support for corporate ethics and a broader movement to enhanced corporate social responsibility?

To start with, we should all worry about the longer-run effects of a sea-change in how people make a living. Employment in companies that make things that you can touch and use and enjoy has been declining for years, while companies that produce ever more complex paper instruments are thriving. And they generate unprecedented wealth for those who create and market them. This includes those infamous Collaterized Debt Obligations that have been tellingly called "among the most toxic instruments ever devised."

Furthermore, I do not think I am alone in deploring the single-minded pursuit of unprecedented personal wealth that permits too many to retire at 55 or 45 or even 35 with more than enough wealth to allow his descendants for several generations to live in Byzantine luxury, without ever having to work a day. This assumes, of course, that someone in the line of descent doesn't do something stupid, always a possibility.

It is hard to believe that the single-minded pursuit of this kind of dynastic wealth encourages its greed-driven practitioners to pay much attention to the broader societal-wide issues and concerns that matter to those in this room. I mean a model of free enterprise that emphasizes efficiency, fairness, sustainable growth and long-run viability.

Could the recent Senate hearings that focused on Goldman Sachs, acting as a proxy for what's been happening on Wall Street, turn out to be a tipping point? Could they provoke a significant change in the culture of Wall Street and even beyond?

Surely, as the Goldman Sachs record seems to confirm, there is something horribly wrong with selling complex tranches of overvalued subprime mortgages while, at more or less the same time in a different part of the company, selling instruments that pay off if those tranches fail. And, worse, holding some of these instruments to profit the company while the unsuspecting customer loses his or her shirt.

In a colorful, but apt, analogy, Goldman Sachs and its CEO, Lloyd Blankstein, have been accused of "selling a car with faulty brakes and then buying an insurance policy on the buyer of that car." And, to make the analogy even harsher, one of Goldman's golden-boy

bankers, Fabrice Tourre, a French citizen, has been accused of selling the car and then sabotaging the brakes!

Incidentally, I don't want to imply that Goldman Sachs were unique in their practices. Hardly.

In a moment, I'd like to conclude with a pointed question for each of you. First, though, I'd like to defend myself in advance against any accusation that I'm biased in my remarks about the U.S., still the world's largest, richest, most dynamic and innovative economy.

As a Canadian, am I being too parochial, too smug, even a little envious? Perhaps, but it's a fact that Canada's banking system has been internationally acclaimed, especially recently, as among the best, if not the very best, in the world. And Canada's economy has weathered the global recession that began in 2007 as well as any other nation. That great international magazine, The Economist, has, in its May 14th issue, not one but two almost embarrassingly laudatory articles about Canada's economic performance!

And, while, over the years, we've suffered a few of our own examples of greed and fraud and deception, some quite high-profile (at least domestically), they pale in significance and in per-capita frequency in relation to those encountered in the U.S.

Obviously there are exceptions to all generalizations. There are many great U.S. corporations, monuments to the efficacy of free enterprise at its best. And Canada's economy and some of its practitioners are not without warts and blemishes. Nevertheless, at the aggregate level, I stand by what I've said to you today.
Now to that pointed question for you to consider. Does what has happened over the past several years, starting on Wall Street, but quickly spreading beyond it, impede or hasten the slow but steady

movement from unbridled Friedmanesque capitalism to a more temperate kind? I mean a kind in which ridiculous excesses are fewer and in which the interests of management are better balanced against those of shareholders as well as against the legitimate interests of other stakeholders.

Some feel that the CSR movement is weakened by the severity of the worst recession in eighty years. They point to the fragility of the tentative recovery. They feel that an exclusive focus on profitability must be paramount, at least until a more enduring economic climate has been restored. They believe that, until this happens, there won't be much stomach in the executive suite for such deferrable measures as embodied in CSR.

On the other hand, there are many who believe, as I do, that the great housing boom and subsequent collapse fuelled by distortions in the risk/reward tradeoff fuelled in turn by rampant greed was a classic folly and an international disgrace never, if humanly possible, to be repeated. I say "international" because, unlike the well-known line that what happens in Vegas, stays in Vegas, what happened on Wall Street spread through much of the industrial world, most notably to many of the countries of Western Europe.

I would like to think that it is self-evident that the principles underscoring CSR will help to make repetition of this black mark against excess less likely. In business, as in life, there are few, if any, guarantees. But these principles can only help.

Thank you for listening to what I hope was more than the angry observations of a temporarily disillusioned observer of the human condition.