How a "Systemic Breakdown" in Ethics Drove the Financial Crisis — And What to Do About It

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During the last several years, as readers of this column know, we've argued that the nation's economic recession has become an ethics recession. Two years ago, in a book by that name, we noted that what first seemed to be an ordinary, off-the-shelf recession was in fact an anomaly. Neither the language of economics nor that of politics could explain it by asking, "Where's the bottom line?" or "Where's the power?" Only by asking, "What's right?" — using the language of ethics — could the nation account for the fierce moral outrage this recession generated.
That point now has been partially recognized in a new report from the Financial Crisis Inquiry Commission. Created by Congress in May 2009, the Commission issued its well-written but controversial 545-page report last month. Of its six conclusions, the final one identifies "a systemic breakdown in accountability and ethics" as a fundamental cause of the crisis. "The integrity of our financial markets and the public's trust in those markets are essential to the economic well-being of our nation," the authors observe. "The soundness and the sustained prosperity of the financial system and our economy rely on the notions of fair dealing, responsibility, and transparency." For the economy to prosper, "we expect businesses and individuals to … conduct themselves well."

Are these just high-sounding platitudes or do these words suggest a useful way forward? The report argues that the collapse was avoidable — "the result of human action and inaction, not of Mother Nature or computer models gone haywire." It points to absences of government regulation, breakdowns in corporate governance, problems of excessive risk taking, and failures of understanding by key policymakers. And it's been loudly criticized by those who think that it minimizes causes that were global rather than domestic, that it fails to offer policy recommendations, that the crisis could never have been foreseen and avoided, or that the level of Wall Street fraud has been understated (according to liberals) or overstated (according to conservatives).

The report also has been pilloried for letting individuals off the hook too easily. When public moral outrage runs high — and I've never seen it more intense than over these past three years — it's convenient to single out individuals like Ponsi schemer Bernard Madoff and former Countrywide Financial CEO Angelo Mozilo — or firms like Lehmann Brothers and AIG — and pile the blame on them. In a nation marinated in a personality-based, *People* magazine view of causation, it's easy to slip into the blame game. Fortunately, as the authors recognize, the bad-apple theory of history simply doesn't explain very much. "A crisis of this magnitude," they write, "cannot be the work of a few bad actors."

Needed, instead, is a recognition that an unethical culture — a "pervasive permissiveness," in the report's words — played a key role in this crisis. Through an "erosion of responsibility and ethics," standards were relaxed, rules were circumvented, and long-term stability was sacrificed for short-term gain. The authors liken the financial environment to a highway having "neither speed limits nor neatly painted lines," observing that "we had a 21st-century system with 19th-century safeguards."

So how do we fix it? When a culture's moral atmosphere becomes this toxic, it's not enough to correct the ethics of individuals. The saddest casualties of the crisis are the legions of otherwise ethical people who got swept up in this moral malaise and lost their bearings. But they weren't the cause of the crisis. Unless the entire culture is rooted in integrity, we'll remain at risk. Not only will we be subject to another cycle of panic and collapse, heightened by faster and more sophisticated technologies, but we'll again go haring off, vigilante style, in search of a few bad actors to lynch. Consoling ourselves that the next crisis couldn't have been foreseen anyway, we'll excuse our inability to spot the signs of a culture in deep distress.

What are those signs? Three come to mind:

- **An indifference to core values.** The Commission's report identifies a number of these values, including responsibility, transparency, fairness, and trust. Cultures of integrity hold these values in high regard and return to them regularly, systematically, and without exception.
- **A failure of ethical decision making.** When smart people use the tools of rational discussion to promote me-first short-termism, they find, in the report's words, that "risk management [becomes] risk justification." Reasoning rooted in values has clearer views of risk, more patience in achieving its goals, and more humility in the face of complexity and nuance.
- **A collapse of moral courage.** When individuals recognize dangers and do nothing, the culture begins to freeze up — as happened at the highest levels during this crisis. In a culture of integrity, where speaking up is rewarded, risks can be foreseen and issues courageously addressed.

In finance as elsewhere, cultures of integrity are built around values, decision making, and courage — operating together, not piecemeal. The Commission's report focused largely on organizations whose flawed ethical cultures led them astray. It's worth remembering that there are organizations with sound ethical cultures that didn't get swept up in this crisis. But that's a topic for another column.