Reflections on Finance and the Good Society

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The economics profession has long had difficulty with popular concepts of "Good Society," concepts that derive from public norms, practices and traditions that often seem incommensurable with economic theory. And yet we can see from the public reaction to the recent financial crisis that we as economists cannot avoid considering such concepts, and particularly at this point in history, cannot avoid evaluating their embodiment in financial institutions.

The Good Society is a human invention, represented by laws, customs, procedures and organizations, that encourages all the complex basic patterns of actual human behavior into an effective and congenial whole. It is a construct for the real world, for the diversity of human attitudes and purposes. Not everyone is "good" in the Good Society. The deep question is whether our institutions contribute to a system that is realistically better than alternatives in helping people to pursue their individual goals. This question is thrown into stark relief with our financial crisis.

In this paper I will consider these issues, and conclude that redesigning finance to advance the Good Society entails consideration of a wide variety of factors, both from theoretical finance and from psychology, history and culture. We as educators are in our best element when we represent the full complexity of the subject to our students. If we do that we help those of them pursuing careers in business and finance to inform their best sense of mission.

I. An Example of the Problems Revealed by the Crisis

The collateralized mortgage obligation (CMO) is a financial invention that divides up cash flows of pools of mortgages into tranches of various levels of riskiness. The core idea, which was extolled by finance theorists such as Claire Hill and Gary Gorton, is to create from a class of hard-to-evaluate risky assets a subclass of riskless securities that is information-acquisition-insensitive, that is, that anyone can quickly judge as riskless without an expensive process of information collection, and without fear of being picked off by unscrupulous promoters of bad

products. The Aaa tranches would be easily sold to the public, while the remaining tranches, including the "toxic waste," would be retained by issuers or sold to knowledgeable speculators. This practice would result in benefits to society, in making mortgage credit more available.

It has been claimed since then by many that the complexity of these CMOs was unnecessary and that it was introduced only to obfuscate, to confuse the rating agencies so that they gave artificially high ratings, so that innocents could be lured by a false sense of security to purchase investments that were not in their interest. Indeed, the collapse of some Aaa-rated CMOs apparently *was* a sign of ethical lapses.

The whole truth about CMOs as a group doesn't point to quite so much evil. The extent of losses after the crisis so far in the Aaa subprime CMO tranches has been much smaller than media accounts suggest, as Sun Young Park has shown. Certainly, there were some unscrupulous issuers of these securities, but they would not have gained such traction were it not for the fundamental ambiguity of the risk environment during the real estate speculative bubble. Not all the issuers understood the faults of their products, since they naturally underestimated the risks of a real estate crisis at a time where we had not had a severe crisis for almost eighty years.

The error revealed by the CMO failures is a subtle one, and in thinking about the future of such instruments and their regulation, we have to understand the limitations of human judgment, the likely limitations in the future after this experience, the opportunities for obfuscation, for entrapment of naïve investors, the life cycle of financial institutions and their incentives to cash in eventually by defying the public trust they have assiduously created over the years, and how all these tendencies can be reduced through suitable regulation.

In short, our students have to understand human behavior and human ethical standards, to know that the financial system that produced the CMOs and other derivatives was not inherently evil, that it had sound concepts that might sometimes be derailed, that they should not adopt a Manichean view of business that sees the financial community in black and white.

II. Reciprocity and Aggressive Human Behavior

A body of research has been accumulating for some years now that reciprocity (a tendency to be nice to those who

are nice to you and vengeful to those who are bad to you, even if it is personally costly to be so) is a fundamental human trait, see Ernst Fehr and Simon Gächter. Brain mechanisms for the theory of mind and empathy that underlie reciprocity are being discovered, see Tania Singer. Because of such fundamental research, economics is moving away from its exclusive reliance on the assumption of atomistic, purely selfish, behavior. To understand how public trust is developed, we need to take account of human patterns of reciprocity.

In his 1936 book *The Good Society* Walter Lippman characterized the Good Society by its adherence to the Golden Rule: "Do unto others as you would have them do onto you." That is not enough to define it, but it is a start. The Good Society acknowledges reciprocity in human behavior. The Golden Rule is often quoted as from Christ, Matthew 7:12, but Christ was hardly original here, only quoting a widely established concept then from multiple religions. Lippman took the Golden Rule not as a uniquely Christian doctrine but as the "ultimate universal criterion of human conduct" that mature people around the world discover and eventually acknowledge in the course of their lives, "however much they may deny it in practice."[1]

Government regulation of financial markets can be thought of as merely codifying rules of a game, rules that are best conceived by the players of the game themselves, much as unsupervised children devise rules for their own games on an empty lot. If the rules are constructed right, there is no defiance of the Golden Rule in playing aggressively in accordance with the rules. We *want* the other team to play aggressively.

It would seem to be obvious, at least to practitioners, that financial innovation can and does contribute to the Good Society, and that financial innovations are important elements of the progress of our civilization. The paper by Andrew Lo in this AEA session provides an example: research on cures for cancer might well benefit from financial innovation. Financial innovation can be a life-saver, and so regulators surely must consider the benefits the innovation, and consider realistically the risk that unscrupulous issuers can exploit opportunities it creates before it interferes with financial activities.

[1] Lippman P. 376

III Regulatory Innovations

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the landmark legislation that followed the 2007 crisis in the United States, seems more focused on stopping moral lapses than on dealing with the kinds of technical instabilities that made the economy so vulnerable to crisis. Nor is it much involved in advancing the powers of financial innovation. Its preamble reads in its entirety:

> "An Act: To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[2]

The language here is predominantly moralizing, suggests protecting from dishonesty, subterfuge and abuse. The 848 pages of the printed version of the Act hardly even mention financial innovation, or systemic interdependence. The Act instead focuses on "the American taxpayer" and "consumers" as victims in need of protection. And yet the financial crisis that motivated the law was substantially due to widespread human psychological tendencies that made possible bubbles in financial and real estate markets, and to a failure to hedge against the collapse of these bubbles. The magnitude of the collapse after the bubbles burst was largely due not to moral faults but to poorly-understood and poorly managed interdependencies and inflexibilities.[3]

The framers of the Dodd-Frank Act were not wrong to address moral issues in the immediate aftermath of the crisis, even if the issues were not central among the causes of the crisis. The public demanded such attention after the crisis.

Moreover, the Act did not confine itself to dealing with abuses of taxpayers and consumers. For example, it also created an Office of Financial Research that studies threats "to the financial stability of the United States." To an economist, these threats would appear generally to lie in the realm of externalities, misunderstood interdependencies and explosive dynamic feedback loops. Alhough these terms appear nowhere in the Act, they might plausibly be studied by the Office that the Act creates. The issues that the financial crisis raises are by no means

[2] H.R. 4173-1 2010.

[3] See for example Case Shiller and Thompson, Foote *et al.* and Gorton.

exclusively moral issues, though the public may tend to think so.

IV Financial Speculation, Larger Society, and Its Traditions

There is a tendency to think that speculation is inherently purely selfish, but this is not necessarily so. A manager of a portfolio for a charitable organization or educational institution must consider the possibility of helping others by speculating. Indeed, in recent years there has been increased professional acceptance of such activities on behalf of philanthropic causes.

Speculation *is* selfish in the sense that successful speculators do not share information freely. They buy and sell on behalf of their own account instead of revealing information and generously providing the information to all of society. As such, it appears inconsistent with religious traditions.

Christ said: "Love your neighbor as yourself"[4] and ""If you want to be perfect, go, sell your possessions and give to the poor, and you will have treasure in heaven."[5] Such an imperative would hardly seem to accord with speculative intent: trading against the interest of another.

The Islamic tradition seems to suggest quite a different, and apparently, to western ears, arbitrary injunction: forbidding riskless interest rather than risky business that entails speculation. But in fact, as Timur Kuran points out, Islamic scholars often inveigh against speculation as well: "This morality includes, in addition to multitudes of restrictions that would hinder complex economic linkages, a major emphasis on generosity as a vehicle for solving social problems."[6]

In the Jewish tradition, there again is a concern against trading on superior information. In The Old-Testament command "You shall not curse the deaf nor place a stumbling block before the blind" (Leviticus 19:14) is widely cited by Jewish scholars. The passage is taken to establish the principle of *lifnei iver* (before the blind) that one should not traffic in other's lack of information. The principle of *umdana* (presumed intent) by some rabbinical interpretations forbids completing a transaction if one equipped with an informational advantage would have

[4] Matthew 22:39
[5] Matthew 19:21

[6] Kuran, p. 439.

walked away from the other side of the transaction.[7]

The Dodd-Frank Act is a hodgepodge of different actions that in some cases seem to put more focus on moral rectitude than the legitimate function of the government in stabilizing the economy. Consider for example its requirement that mortgage originators retain five percent of the mortgage portfolios they originate, subject to some exceptions. By retaining ownership of part of their issues, originators do signal their good faith in the product. But government intervention here is something of a puzzle, given that existing businesses already signal their good faith in various ways. Still, the new law may derive popular support as a measure of economic justice, amidst the outrage against bad-faith dealings before the crisis.

Alvin Roth has pointed out that "repugnance" at certain kinds of market activities explains a good deal of our legal restrictions on markets. He points out that a referendum prohibiting the sale of horse or dog meat at California restaurants passed by a wide margin in 1998, even though this prohibition does not prohibit killing of horses or dogs, and does not even prohibit their killing to manufacture pet food. Moral repugnance may seem arbitrary, and even nonsensical to economists, but it is part of our ethical traditions, that need to be respected.

There is indeed some repugnance against the lifestyle of some wealthy speculators, and this accounts for some of the attitudes that gives rise to regulations. There is some general public repugnance at the lust for wealth accumulation that some avid businessmen seem to display. This lust may be a milder form of the mental illness called compulsive hoarding, which psychiatrists find common and probably distinct from the obsessive compulsive disorder.[8]

And yet most people, who observe such aggressive hoarding behavior among some businesspeople, are able to accept their behavior. As long as we live in a Good Society that respects and encourages all people, we can tolerate the riches of some people, who have won in a game that most of us have chosen not to play.

[7] Levine p. 155.

[8] The fourth edition of the *Diagnostic and Statistical Manual of Mental Disorders* (DSM-IV) published by the American Psychiatric Association lists compulsive hoarding as a symptom of obsessive-compulsive disorder but for the next edition there is talk of singling out compulsive hoarding as a separate disorder. See Wu and Watson 2005.

V. Teaching of Economics, Business and Finance

Teaching of economics, business and finance in our colleges and universities would benefit from greater attention to the financial institutions and to the multitude of specialties within these institutions, and attention to their social norms and ethical standards.

It is barely mentioned in most textbooks that there are professional organizations within each of the finance and insurance specialties. These organizations promote ethical standards.

It is true that these organizations do not usually trumpet moral imperatives, and that discussions at their meetings rather more focus on profit opportunities and personal career development. But there is still a strong shared concern with moral rectitude, a concern that is often conveyed within these organizations by the norms as to what is off-limits to discuss, or what are assumed patterns of professional behavior. Much of this is nearly invisible to outsiders: it needs to be made more visible.

The teaching of finance might as well focus more on the philanthropic side of the financial professions. The apparently selfish and irreligious speculative activity that we see can be offset by the other activities that speculation, at least in some circumstances, supports.

The teaching of finance and its value system is a precursor to financial regulation. It can ultimately set the stage for improving the social norms in business even further, and making for a yet better society.

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