CRT Principles and the Crisis

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The best test of a principle, perhaps, lies in its effects, not always in its aspirations. Does it lead to constructive action? Can it influence and shape behaviors for the better, especially dysfunctional behaviors?

On the one hand we can judge the quality of a principle according to a moral calculus of abstract standards of right and wrong. But, on the other hand, we can also assess the practical worth of a principle by its power to achieve ethics in the field. This might be considered the inherent potential of a principle to obtain compliance with its preferences for better outcomes. As Karl Marx said in his Theses on Fuerbach, "Up to now philosophers have only interpreted the world. The point, however, is to change it."

This seems especially relevant in the arena of corporate responsibility and business ethics. Overcoming the functionality of greed and short-term self-interest is the goal of those who promote responsible decision-making in business. And a daunting task they have.

The Caux Round Table published a set of ethical principles for business in 1994, the first such set of principles for guidance of global business and the only set of such principles yet designed by experienced business leaders.

The current massive disruption of financial markets initially brought on by the collapse of the sub-prime mortgage market in the United States provides an opportunity to assess the relevance of the CRT Principles for Business.

If they had been followed, are there reasonable grounds to believe that the crisis could have been avoided, or at least mitigated in scope and intensity?

I think the answer is, yes, the CRT Principles might have made a difference had they been infused in strategic and tactical decisions on the part of those financial institutions which contributed to the current crisis.

First, let us consider the implications of the first CRT Principle for Business:

"The value of a business to society is the wealth and employment it creates and the marketable products and services it provides to consumers at a reasonable price commensurate with quality. To create such value, a business must maintain its own economic health and viability …"

Since the crisis is about the failure of major financial houses and banks such as Bear Sterns and Lehman Brothers, the sale of others such as Merrill Lynch and Washington Mutual, and the government rescue of Freddie Mac, Fannie Mae, AIG, Fortis, and others, we can quite quickly conclude that these companies failed to meet the ethical requirement of maintaining their own economic health and viability.

Their decision-making was wrong-headed in the accumulation of too much debt and in setting imprudent values on certain financial assets such as sub-prime home mortgages and CDOs. In their collapse, these firms caused a contraction of markets, thus erasing wealth and employment in violation of what the CRT advocates as the primary obligation of business firms.

Second, the current crisis was caused by a failure to provide quality products at a price commensurate with their inherent worth.

Sub-prime mortgages were priced inappropriately for many borrowers. Excessive and imprudent borrowings were offered to home owners. In the many cases where credit standards were waived or overlooked lenders and mortgage brokers knew or should have known as professionals that the borrowers were highly likely to default if economic conditions changed.

Borrowers were effectively sold defective financial products. Such mortgages were also sold in excessive quantities, creating an asset bubble that gave rise to perverse incentives on the part of home buyers to assume unreasonable risks of future default and foreclosure.

Similarly, the terms of many CDOs sold were not of the value that was represented to buyers. They carried more risk than was reasonable for the investment goals of those who purchased them. They were also issued in excessive amounts that undermined their long-term value.

This requirement to serve customers with respect for their needs is reinforced in Section 3 of the CRT Principles for Business with the requirement that businesses *"provide their customers with the highest quality products and services consistent with their requirements."*

The first CRT Principle also holds that:

"Businesses have a role to play in improving the lives of all their customers, employees, and shareholders by sharing with them the wealth they have created."

Here has been the greatest harm done by those who create the unsustainable markets in sub-prime mortgages and CDOs – they destroyed wealth and made worse the lives of many customers, employees, owners, creditors and communities.

Principle No. Three of the CRT Principles holds that:

"… businesses should recognize that sincerity, candor, truthfulness, the keeping of promises, and transparency contribute not only to their own credibility and stability but also to the smoothness and efficiency of business transactions, particularly on the international level."

The current crisis in financial markets was caused by a lack of sufficient transparency in CDOs valuations which eventually undermined the smoothness and efficiency of international markets for credit and liquidity.

Principle No. Four of the CRT Principles holds that:

"[Businesses] should recognize that some behavior, though legal, may still have adverse consequences."

It appears that in general, the provision of the financial products that gave rise to the crisis was legal. No laws were violated in lending to sub-prime borrowers or securitizing those mortgages and selling off interests in them through CDOs and in providing guarantees of payment through credit default swaps. Individuals here and there are being investigated for fraud in the sale of such products, but the products themselves were legitimate in concept. What went wrong was selling them to excess on unsustainable terms. That behavior, though legal, had adverse consequences that should have been foreseen and avoided.

With respect to their owners, those responsible for the credit crisis failed to meet other responsibilities set forth in the CRT Principles for Business. For example, they failed to "apply professional and diligent management" and to "conserve, protect and increase the owner's/investors assets". These failures lay at the heart of the dynamic that caused the crisis. There was strategically poor judgment exercised in the development of these markets. Risk was exacerbated to the point of destabilization; it was not properly foreseen or managed.

And, finally, those who caused this crisis failed to meet the CRT standard of enhancing community environments and standards of living. Where homes go into default when mortgages can't be paid, communities suffer disinvestment and even blight as home prices fall and homes are abandoned to the lenders.

Had the boards of directors and senior managers of Bear Sterns, Lehman Brothers, Merrill Lynch, Citibank, Morgan Stanley, Goldman Sachs, Washington Mutual, Freddie Mac, Fannie Mae, and others who thrived for a while off the issuance of sub-prime mortgages and CDOs taken their CRT responsibilities more seriously – and insisted on products and sales strategies consistent with those practices – there would have been less risk injected into the global financial system and less provision of unsustainable financial products.

As I wrote a few years ago in Moral Capitalism, "Directors and corporate officers are hired to be agents not just for their fidelity but also for their skill. Their responsibility is to guard against high risk and imprudent courses of action."

In that book, I also pointed to the intertwining of interdependencies and the need for trust in transactions. Capitalism breeds interdependencies through the specialization of function and the division of labor. Reliance and trust are essential for capitalism to thrive.

Destruction of either leads to trouble in markets. People lose confidence and withhold their ideas, labor, and capital from productive exchange. The economy then contracts. That is what is happening now. The current crisis is really only a crisis of confidence; trust has been lost.

But how do you restore trust when it has been abused?

I wrote in *Moral Capitalism* that "where mistrust prevails, people fear entering into dependency relationships. Mistrust always raises the risks of enterprise. Who would invest where risks are excessive and returns uncertain?"

This dynamic explains the collapse of value in Bear Sterns, Lehman Brothers and Washington Mutual – they had billions of dollars of assets on their books but no one wanted to buy their shares. The value of Bear Sterns was $80 per share on the books, but only $2 per share in the market. Lehman Brothers went bankrupt and its owners could not realize the value of the company's book assets as no one wanted to buy those assets encumbered as they were by debt and uncertainty.

I also noted in *Moral Capitalism* the sometimes negative effect of desire for money. "The interest of owners and investors in making money introduces a challenge to moral capitalism. Money is easily idolized, provoking heresy by turning us away from the things of God to the things of Mammon. There are times when we may sell our souls to gain what money promises in way of power and license. This is especially true in today's culture of consumerism, where we have sanctified appetite over character."

How much did this dynamic contribute to the current crisis?

I close these thoughts with a quote from an ancient Chinese text, the Annals of Lu Bu Wei, who wrote about 250 BCE

"In making judgments, the early kings were perfect, because they made moral principles the starting point of all their undertakings and the root of every thing that was beneficial. This principle, however, is something that persons of mediocre intellect never grasp. Not grasping it, they lack awareness, and lacking awareness, they pursue profit. But while they pursue profit, it is absolutely impossible for them to be certain of attaining it."