

The Ethical Leadership Profile and Our Financial Crisis

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The current collapse of asset values that started with sub-prime mortgages in the United States and flowed to global credit markets through the intermediation of CDOs and Credit Default Swaps is but another example of “irrational exuberance” at work in financial markets.

Allen Greenspan, former Chairman of the US Federal Reserve System, coined the cautionary term “irrational exuberance” to describe the asset bubble in dot-com and telecom equity stocks in the late 1990’s. That bubble burst when the accounting fraud scandals at Enron and WorldCom exposed many company values as illusory.

“Irrational Exuberance” takes over markets when prudent judgment and sound valuation methodologies lose traction in the minds of investors. Speculation, grounded on expectations of ever rising equity values, drives out sound thinking and ushers into financial markets mere enthusiasm for short-term profit taking.

Certain styles of decision-making tend to favor the rise of “irrational exuberance” over more responsible approaches to valuation.

The *Ethical Leadership Profile*, a decision-making preference questionnaire developed for the Caux Round Table by Michael Labrosse and his associates, indicates that there are, in general, four distinct decision-making modes of thought that most people use when making decisions.

First is the *Inquiring* frame of mind. This approach to decision-making emphasizes analysis of data, conceptualization to see the “Big Picture” and to discern future trends, to find meaning in facts by giving each of them contextual weight and by putting them into patterns and categories. Here we find much of Barack Obama’s approach to decisions.

Second, and opposite to the approach taken by Inquirers, are the *Pragmatists*. These people look to experiences of practical success as the guide to their choices and recommendations. They are focused on immediate results within the context that is given them by society’s institutions. At their best, they have a dedication to craft and substance in what they do or produce. They tend to ask how can we complete the task and less why should we be doing this? The “why” question is of more interest to Inquirers than to Pragmatists. George W. Bush and his father, George H.W. Bush, both lean heavily towards pragmatism in their decision-making. George H. W. Bush became known for his cautionary mantra: “Wouldn’t be prudent.”

Third, on a different dimension than the continuum linking Inquirers and Pragmatists are the *Unifiers*. Their preferred approach to decisions is to find what is best for the organization to which they belong and for them as a loyal member of that structured community. They place priority on resolving issues of hierarchy and fairness within the organization; they place loyalty to their group over concern for outsiders; they stand up for their peers and reward loyalty with loyalty. They may often defer to the organization's rules and regulations and thus appear bureaucratic and happily bound up in red tape. Hillary Clinton with her passion for control and her distance from outsiders seems to have much of the Unifier orientation in her personal approach to the use of power.

Fourth, and opposite to Unifiers are the *Entrepreneurs*. They plan their moves with most concern for their own recognition and advancement. Their loyalty to the group responds to the group's interest and ability to advance their careers and ambitions. Entrepreneurs are responsive to others, creative, intense and industrious. They are always drumming up some kind of profitable business for themselves. John McCain with his penchant for quick and decisive action would seem to embrace much of the entrepreneurial spirit in his approach to decisions.

But people are rarely active only at one of the paradigmatic poles; more frequently, they combine something from the Inquirer/Pragmatist axis and something from the Unifier/Entrepreneur axis. So, we might consider Bill Clinton as an Entrepreneurial Inquirer – a man focused on his own opportunities but with strong intellectual gifts. Barack Obama would be an Inquiring Unifier, bringing conceptual clarity to the tasks and challenges of the organization and looking at the whole of the group and not just partisan sub-cultures. George W. Bush with his war in Iraq would be comfortable mixing pragmatic action with entrepreneurial risk.

Of these four dispositions, being an Entrepreneur is most conducive to promoting “irrational exuberance”, especially when compensation structures are commission or fee based so that deals done translate directly into personal reward and advancement. Entrepreneurs are less likely than Inquirers to consider the long term consequences for others of what they are doing. Entrepreneurs have a propensity to see the world in terms of sales; if you can sell it, do so and let the buyer beware of the consequences. You will move on to the next deal.

Nor are Entrepreneurs that considerate of the risks to their organization. They think of themselves not their organization as the vehicle of opportunity and success.

But when Entrepreneurs and Unifiers are mutually engaged in the same business, it can be a very risky combination. If the Entrepreneurs are “bringing home the bacon” for the organization, the Unifiers will stand by them, reward them, and not question the effect of their activities on those outside the organization.

In the case of Enron, both Jeffery Skilling and Andy Fastow were of the Entrepreneurial frame of mind. As long as they produced ever growing revenues for the Company, Ken

Lay, the Enron Board, Arthur Anderson partners working in effect for Enron, and others loyal to the company had no complaints and rewarded them with high compensation and discretionary power. The conflict of interest rule was waived for Fastow so that he could be even more entrepreneurial for both himself and Enron.

In the companies that promoted the sub-prime mortgage bubble, the CDOs that derived from those mortgages, and the credit default swaps that were to give added security to those CDOs, Entrepreneurs and Unifiers came together with toxic consequences. Their business marriage of convenience led to a massive over-leveraging and resulting asset bubbles in housing and derivative CDOs.

Entrepreneurial mind sets kept up the deal flow for both sub-prime mortgages on more and more risky terms and CDOs which were sold in ever increasing amounts. Compensation for placement of mortgages and issuance of CDOs was fee based, an incentive system perfectly fitted to drawing out Entrepreneurial thinking and behaving in financial services.

As the asset bubble was growing and fees were being earned, Unifiers like the senior managements and boards of Merrill Lynch, Bear Sterns, Lehman Brothers, JP Morgan Chase, Citibank, AIG, etc., were loath to reign in their productive agents. Concern for the benefits to the organization trumped more strategic thinking about if and when the bubble should ever burst and prices would fall.

Pragmatists were thrown into the task of churning out more and more of deals that could earn fees. They were happily employed serving the goals set by the organization that gave them tasks and rewarded them for accomplishment.

Inquirers were largely left out of the decision-making dynamic that gave us the current economic crisis. Inquirers were valued only to the extent that they could rationalize and justify with complex calculations and algorithms the deals that were being promoted by the Entrepreneurs.

Had the governance of these financial institutions been more evenly divided among Inquirers, Unifiers, Pragmatists, and Entrepreneurs, outcomes might well have been different.

More strategic thinking from Inquirers about long-term trends and consequences might have undercut the rush to “irrational exuberance”. More focus by Pragmatists on producing quality products that were reliable and durable would have slowed the deal flow and dampened down the accumulation of debt and the scope of the bubble in asset prices.

The possible learning from this reflection on the four decision-making tendencies highlighted by the Ethical Leadership Profile is that application of the Profile and seeking a proper balance of decision-making styles might have minimized the onset of this global crisis.