UNPRINCIPLED INVESTMENTS: INTERNATIONAL COMPARATIVE LESSONS FROM THE FINANCIAL CRISIS OF 2008

by

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ABSTRACT

My research compares the causes of and responses to the Financial Crisis of 2008 in the United States and Iceland. The article's central question is whether the United States can learn any lessons from the comparison given the significant differences between the two countries. The United States took conservative political measures to address the causes of the financial crisis, whereas Iceland did not bail out its most prominent banks, took high-level executives and political figures to court for their roles in the lead-up to the crisis, and even attempted to rewrite its constitution in the wake of 2008. To conduct my research, I utilized numerous primary and secondary texts from such disciplines as economics, philosophy, and law. My conclusion is that the causes of the financial crash of 2008 were not only rooted in economics but in the failure to consider the way economic reasoning impacts moral and ethical principles and practices in civil society. Consequently, Iceland’s reaction is more responsible than the United States’ because of the radical steps that it took to respond to the crisis. The way that Iceland addressed the ethical dilemmas imbedded in the causes of the financial crisis was superior because of the way it publicly addressed these problems in the court and legal system. Although there are certain limitations to the United States embracing Iceland's response, the U.S. can still learn from Iceland’s response and thereby develop a better strategy to address financial crises in the future.

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Introduction

In the 2013 film Blueberry Soup, a wide shot of someone climbing one of Iceland's stunning mountains shifts frame to a man on a leather-bound couch talking to the documentarians who have asked for his perspective on the 2008 financial crisis. The interviewee, Jonas Antonsson, is the Founder and CEO of Gogogic Game Company, an independent video game business that was founded in Iceland. However, instead of talking about how the financial crisis negatively impacted his business, he talks about how the economic zeitgeist has maybe done the island's people some good:

The good thing about a crisis is that it forces people to think. You have to think. You can no longer go about your daily routine. So it forces you to start to question things around you. Why things are like this and not like that. So I think that to some extent maybe people are more aware of themselves, and are more aware of life in general and their society than they were before [the financial collapse]. Hopefully, at some point, most of them or many of them will realize that, that is actually a good thing, and hopefully they will be able to carry that into better times. (Jerrett, 2013)

The financial crisis of 2008 did not just leave American homeowners in the streets, kicked workers out of a job, and saddled retirees with the anxiety of losing the value of their pension fund, but it also affected numerous countries around the world. The effects of the Great Recession left the body politic of many countries feeling like they had been deserted by the financial advisors who had promised never-ending and continuous growth of their investment returns and government agencies that, instead of enforcing the rule of law, had overseen mass privatization and deregulation of the financial sector. However, when these newly privatized banks went under, there was no one in government that wanted to own up to the fact that their actions had contributed to the plight that the ordinary citizen of their respective countries now faced. While this initially led to anger for the masses, there is a kindling of hope that comes about with watching institutions that are too big to fail wither away like a banknote caught ablaze in a fire, as Jonas does:

[There came a realization that] all we interact with is someone's idea. A plane, the monetary system, the banks, the government. These are ideas that become reality through the creation process. You start to understand that you have a much deeper or bigger impact in this whole process than you think you can have because it is much more fun to be a part of the creation process than just be a consumer of it. We've seen where consumerism leads [us]. If you understand the creation process, you can start to live your own dreams instead of [being] stuck in the dreams of others. (Jerrett, 2013)

The idea that Jonas strings along has the force to enact substantial change if followed through, but to what extent have societies rethought the place that capitalism holds in our communities? The rest of this paper seeks to answer this very question. However, instead of looking through the past financial histories of many countries that the Great Recession has impacted, the primary focus will be on two countries, the United States and Iceland.

First, this thesis will discuss the appeal of neoliberalism from the perspective of the philosopher Michel Foucault. In doing so, we will highlight the broad appeal that neoliberalism had not just among a specific part of the political spectrum but its promotion from an icon of the left. Also, his approval of at least some parts of the neoliberalism agenda will shed light on how a once registered member of the French Communist Party can switch to embracing free-market ideology. With this, a new idea about how markets can be used to replace moral decision-making will be examined.

The views of neoliberalism (as expressed via the example of Foucault) will be followed by considering the question that Jonas raised of the role of markets in society. This includes moral and ethical issues raised by distinguishing between speculation and investing, by addressing the distinction between fines and fees, and by exploring the viatical industry.

This will be followed by an examination into the causes of the financial crisis in both the United States and Iceland. This background sets up a consideration of the response programs to the financial crisis, first in the United States and then Iceland. These responses will be discussed in terms of neoliberalism and other ethical and moral views. Finally, an analysis will be conducted as to whether Iceland can be used as a case study in how to bounce back from a financial crisis and might lessons might be learned from the perspective of the United States.

Chapter 1: Michel Foucault and the Appeal of Neoliberalism

Michel Foucault is a name that towers in 20th Century philosophy to the likes of a Fredrick Nietzsche, Sigmund Freud, or Karl Marx. While his thought has permeated the lexicon of discussion around such topics as feminism, queer studies, postcolonial studies, and postmodern philosophy, he is still a force that defies labels or compartmentalization to one branch of philosophical tradition. (Behrent M. C., 2016, pp. 24-25) Foucault himself would even go so far as to endorse a wide breadth of his work that defies a cohesive label as someone who fits neatly into one category of thinker. For example, in an interview shortly before his death, Foucault asserted that:

I think I have in fact been situated in most of the squares on the political checkerboard, one after another and sometimes simultaneously: as an anarchist, leftist, ostentatious or disguised Marxist, nihilist or secret anti-Marxist, technocrat in the service of Gaullism, new liberal etc. … None of these descriptions is important by itself; taken together, on the other hand, they mean something. And I must admit I rather like what they mean. (Foucault, Polemics, Politics, and Problematizations, 1984)

Given his embrace of nonconformity, it is important to note that, while this paper discusses his flirtation with the beginnings of the neoliberalism movement in France, it by no means labels him as a neoliberal. To label him as such would be far too reductionist to be accurate; that would miss the mark of any productive philosophical understanding that we could gain from Foucault's work. Instead, we must realize that "it is not a matter of being 'for' or 'against' Foucault, but rather of discussing, engaging with, and critiquing him to grasp the extent of his influence and the issues he opened up in the intellectual field." (Zamora, Foucault, the Left, and the 1980s, 2016) With this in mind, Foucault serves as a figure who serves as an example of a leftist icon who came to embrace market fundamentalism as a way to move away from what he viewed as the outdated bureaucratic methods of the welfare state.

The French Economic Crisis of 1973

An understanding of Foucault's perspective on economics necessitates some background about the times in which he wrote. In the thirty-year period following World War 2, also known as the *trente glorieuses* ("thirty years of glory"), the French economy was marked by incredible expansion, particularly between the years 1960 and 1973, where the gross domestic product (GDP) averaged an increase of approximately 6 percent over each year. (Britannica, 2021) The end of this period was met when, in 1973, OPEC decided to triple the price of oil; however, some trace the economic decline to a time as early as 1971 when President Nixon ended the gold convertibility of the U.S. Dollar. (Behrent M. C., 2016, p. 32) Nevertheless, due to the economic situation of France at this time, this economic hardship allowed for voices from the more libertarian-leaning side of the study of economics to come into the political fray. (Behrent M. C., 2016, p. 33)

In the face of the issue of inflation and other economic woes, President Valery Giscard d'Estaing appointed Raymond Barre, a liberal economist and translator of Friedrich Hayek, one of the principal figures in the neoliberal Austrian School of Economics, as prime minister in 1976. (Behrent M. C., 2016, p. 33) Under this new role, Barre would oversee the development of some deregulation that would ultimately come to define his tenure. In fact, the prime focus of his term would be to repeal price caps on commodities and services that had seen them implemented since the mid-1940s. The most symbolic of these would be the removal of the price cap of the hallowed baguette. (Behrent M. C., 2016, p. 34) While it surely does not seem notable at first glance, many view Barre's reforms as only the first step to the end of the French statist model of embracing Keynesian ideology and methods of controlling inflation and other economic fluctuations. However, these initial steps toward a different way of government would serve as a touchstone for other thinkers in the French political scene. Although they had formerly embraced Marxist ideology, they moved toward a critique of the system of governmentality and aspired to an ideal that is more aligned to the ideas of neoliberalism.

The Idea of Neoliberalism

Before delving further into the conditions that lent to the appeal of neoliberalism for Foucault, a discussion on the definition of this early form of the free-market creed needs to be held. There are two branches of liberalism that need to be distinguish between one another: economic and political. Economic liberalism is defined as "a school of thought that holds the free market to be the most efficient of the economic systems." (Behrent M. C., 2016, p. 56) Political liberalism is a "philosophy that advocates [for] representative governments grounded in law and guaranteeing fundamental human rights." (Behrent M. C., 2016, p. 56) Distinguishing between these two is paramount to understanding the attraction that Foucault had toward neoliberalism because of his extreme stance against humanism, as it is fundamental to embracing political liberalism.

The foundations of neoliberalism are built upon the economic liberalism ideal. These foundations come from the renewed interests by Ordoliberalism and the Chicago School of Economics, which came as a result of rethinking the Keynesian economics that was embraced in post-World War 2 economic agendas through programs like the U.S.-backed Marshall Plan. This distinction between the Keynesian and neoliberalist perspective on the role of government intervention in the economy is also central to one understanding neoliberalism as they are diametrically opposed to one another.

"Keynesian economics is based on the notion that underemployment arises when total or aggregate demand in an economy falls short of the economy's ability to supply goods and services." (Blinder, 2013, p. 211) To alleviate the shortfall in demand, the government takes the initiative to step into a market to supplement the demand deficit by using fiscal controls that it has at its disposal. John Maynard Keynes, the founder of Keynesian economics, argued that "governments can boost employment by cutting interest rates (what we now call looser monetary policy), raising their own spending, or cutting people's taxes (what [is known] as looser fiscal policy)." (Blinder, 2013, p. 211) On the other side of the spectrum, if there is deemed to be too much demand, "governments can fight actual or incipient inflation by raising taxes or reducing its own spending (thus tightening fiscal policy)." (Blinder, 2013, p. 211) Thus, the principle that is implicit within this economic theory is that government has a responsibility to balance market demand by utilizing both monetary (generally controlled by a central bank that regulates interest rates and serves as a lender of last resort) and fiscal policy (in the case of the United States, this is controlled by the legislative branch through its power of the purse).

Opposing Keynes and his economic philosophy are economists such as Friedrich August von Hayek (leader of the Austrian School of Economics) and Milton Friedman (central figure to the Chicago School of Economics). While the system of thought that they constructed is surely complex, the key underlying value is the idea of market fundamentalism. This view, exemplified in such fiscal policy from national leaders such as Margaret Thatcher and Ronald Regan, makes specific use of ideas such as Adam Smith's invisible hand theory, an "argument that firms who pursue their self-interest and the maximization of profits would lead, as if by an invisible hand, to general societal well-being." (Stiglitz, 2009) This sentiment, in turn, leads to the idea that the government that does its best to stay out of the business of the economy is the ideal one. As opposed to Keynes and his idea of an active role by government in the economy, neoliberalism holds that government actors should not utilize their policy and regulatory powers to interfere with the supply and demand of a market and instead have a laisse-faire approach to avoid market manipulation. With this understanding of neoliberalism and its foundational idea, this chapter turns to Foucault's philosophy and how his views were molded by the economic conditions of his time.

Discipline and Biopower

Discipline and Punish, Michel Foucault's 1975 work on the issues of the French carceral system, was a pivotal point in his career. In that book, he concluded that the prison system was the pinnacle of a force that he named discipline to exert power over the individual. This entity was further characterized as a way to control by means of surveying the body, "normalizing their behavior, and regulating their movement."

(Behrent M. C., 2016, p. 40) As opposed to the old system, which exercised power through public displays of punishment and torture, discipline was not just used on criminals but on students, medical patients, and soldiers as means to impact the character of the individual to compel them to act in a way deemed favorable by the state without direct supervision but yet to control movements by the creation of a surveillance state in which no one knows if they are being monitored at a given time. Under the pressure of being watched by the state, individuals are compelled to act as if they are being watched without ever truly knowing if they are being watched at all. Thus, the power of the state is ensured by making the individual a supervisor of the state in which they limit their own behaviors in accordance with the norms of the state. Additionally, Foucault also saw discipline as a mechanism that the most modern form of power relations between a state and its citizens, as well as one that made true liberty impossible to achieve within a society. (Behrent M. C., 2016)

In 1976, Foucault came up with a new form of power that he viewed to be more contemporary than discipline: biopower. What distinguished biopower from discipline is that it focused less on individuals and more on controlling populations as a whole by defining itself in its promotion of life – “through the production of wealth, the promotion of public health, and, in general, the maximization of a population’s life forces.” (Behrent M. C., 2016, p. 41) Foucault did not disregard discipline altogether but instead put it as an intermediate step that made biopower possible through the historical dialectic. By claiming that discipline was inferior to the mechanisms of biopower, Foucault had already forfeited one of the central arguments that defined

Discipline and Punish. It also allowed him to delve into more contemporary ideas on the art of governing, such as the beginnings of the neoliberalism movement. (Behrent M. C., 2016, p. 41)

In a 1978 course, Foucault would renounce his thesis on discipline entirely and instead embrace biopower as not just another mechanism for state control of the populace but as a doorway to promoting liberty that is rooted in systemic change rather than in humanism or political liberalism, which he fiercely opposed throughout his work. (Behrent M. C., 2016, p. 43) In the lecture, Foucault stated:

That one could not understand the establishment of liberal ideologies and political in the eighteenth century without keeping in mind that this same eighteenth century, which had demanded these liberties so forcefully, had nonetheless weighed them down with a disciplinary technique which, taking children, soldiers, workers where they were limited liberty considerably and, in a sense, gave guarantees to the very exercise of this liberty. (Foucault, Security, Territory, Population, 1978)

This portion of the lecture fundamentally demonstrates Foucault's departure from his conception of discipline that he espoused in earlier work. He instead focused on biopower as the new way for the state to effectively wield power while embracing neoliberalism as a method to unshackle biopower from the unnecessary constraints that discipline puts on the ability for citizens to exercise freedom. In doing so, he would endorse and be influenced by two groups of proto-neoliberal groups to turn his theory into actual governmental practice. In making this decision, he stepped away from simply making a theory about government and instead sought to develop governmentality (a term used to refer to how governments operate pragmatically) as opposed to just coming up with a political theory that cannot make the leap from page to actual actionability.

The Physiocrats and Ordoliberals

The first group that Foucault utilized to argue for economic liberalism as a means of achieving liberty were the Physiocrats. The Physiocrats were an eighteenth-century group that are renowned as creating "the first strictly scientific system of economics" that held that "the wealth of nations derived solely from the value of agriculture." (C.W., 2013) Their significance primarily lies in the methodology of their economic principles and not in their ultimate conclusion about the role of agriculture in an economy. Foucault was inspired not simply by their thoughts on agriculture but specifically in how a "natural order" can help to prevent economic calamities such as grain shortages. (Behrent M. C., 2016, p. 42)

The idea from the physiocrats was that government intervention to try and guard against grain shortages ultimately exacerbates the issue instead of solving it for its citizens. This group ultimately proposed that it would be best to "abolish price controls across the board [which would ultimately tempt] the profits that they hoped to make from an ensuring spike in prices, hoarders and foreign exporters would flood the market with grain – which, in turn, would lower prices and feed the hungry." (Behrent M. C., 2016, p. 42) This type of instance embodies the term "laissez-faire" and was actually first coined by the physiocrats before it became the motto of the neoliberalists. (Behrent M. C., 2016, p. 42) Ultimately, what drove Foucault to examine and adopt the physiocrats' idea of governmentality is the underlying principle that power directed at populations promotes more freedom in a society than one that directs its power toward individuals because focusing on the aggregate inversely allows for greater autonomy of the individual.

Despite having the methodology of the physiocrats, Foucault was more influenced by the Ordoliberals, a group that was working during Foucault's time. The Ordoliberals claimed that government should have a role in the economy, so they were not strictly laisses-faire, but they did not go as far as the Keynesian view. Instead, Ordoliberals believed "that capitalism requires a strong government to create a framework of rules which provide the order (ordo in Latin) that free markets need to function most efficiently." (The Economist, 2015) In essence, Ordoliberals held that the government should not be inactive but that it should facilitate the market by laying down legal protections that ensure protection and security for entrepreneurs and investors. Thus, the government has an interest in using power in a way that limits itself while also facilitating the growth of individual liberty by providing a framework for the economy to flourish. This the government does by maintaining only legal guarantees instead of using monetary and fiscal policy to influence economic conditions. More importantly, though, Foucault would utilize this neoliberal philosophy to advocate for ways in which government could exert its power using purely economic determinatives instead of operating in a way where institutions operate with a neutral face but implicitly hold moral judgments over its citizens to participate in a social welfare system.

The Welfare State, Negative Tax, and Morality

Foucault's primary issue with the welfare state, when examining it in its governmentality, is that it ultimately acted as a way for governments to standardize the conduct of its populace by making them dependent on the state's social safety net programs to survive. If the government deemed a certain citizen to not fit within a certain normalized set of criteria and behaviors, then that citizen would be excommunicated by not having access to support from the state through welfare programs. As Foucault had stated in 1983, "our systems of social security impose a particular way of life to which individuals are subjected, and any person or group that, for one reason or another, will not or cannot embrace that way of life is marginalized by the very operation of the institutions." (Foucault, Social Security, 1988) Thus, it can be taken with certainty that Foucault sought to break away from a social system that utilized biopower in a way that was still tethered to the subordinate power of discipline.

One of his intellectual followers, Francois Ewald, wrote a book dedicated to the welfare state and biopower under Foucault's direction that also sheds further light on how the philosopher saw the welfare state as an institution that suppressed the exercise of individual liberty. In the book, Ewald writes that "the welfare state fulfills the dream of 'biopower.' The welfare state is a state that is intended not so much to protect individual freedom against the aggressions it may undergo from others as to support the very way that the individual manages his life." (Ewald, 1986, pp. 374-375)

Ewald goes on to say that “if the welfare state, like the liberal state, focused on the economy, it is no longer an economy of material wealth, but an economy of life.” (Ewald, 1986, p. 375) This line of dialogue supports the idea that Ewald and Foucault see the governmentality of a liberal government toward the economy as not just simply an economic methodology but as one that has the potential to enable the liberation of the individual from the surveillance of the disciplinary state. (Zamora, 2016)

The issue that Foucault took up with the social welfare system also demonstrates another turn from communist ideology in which the philosopher began to emphasize more issues related to equality of opportunity as opposed to equality of outcome. Instead of taking up the old Marxist crusade to have the proletariat take over the means of production, Foucault believed that seizing the reigns of industry does not on its face lead to more equality of opportunity. (Zamora, 2016) The focus on fixing inequality for outcomes such as wages, in Foucault’s stance, does little to fix the of getting rid of the disciplinary mechanisms of the state. This is because the state’s active role in the redistribution of wealth creates the concern that a welfare state may form to marginalize certain groups that the government deems as fringe, undesirable, or a threat to keeping the status quo.

Foucault also became enamored with Milton Friedman’s idea of the negative tax as a form of government action that could replace social welfare programs without the normative controls of a disciplinary state. (Zamora, 2016) The negative tax is an idea, somewhat similar to recent programs of universal basic income, that purposes that the government pays citizens that make under a specific income as a way to promote welfare. Where would the money for payouts come from? The money that would come from the funds freed up by the end of public services. Foucault further endorses this system in his lecture series, *The Birth of Biopolitics*, where he states that:

The famous distinction that Western governmentality has tried for so long to establish between the good and bad poor, between the voluntary and involuntary unemployed… After all it does not and should not concern us to know why someone falls below the level of the social game; whether he is a drug addict or voluntary unemployed is not important. Whatever the reasons, the only problem is whether he is above or below the threshold. (Foucault, The Birth of Biopolitics, 2010)

Why, though, should it not matter if the government subsidizes the income of a drug addict or a self-imposed vagabond? The idea that we can let markets and economics take over the distribution of wealth and replace the welfare state and social programs is wrong because Foucault makes one fatal mistake that many other economists are at fault for, too, which is the assumption that economics is nonnormative and dispenses with ideas of good and bad to instead focus on what is most efficient to allocate goods and services. However, bypassing public discussions of morality in a society is not the way forward to the betterment of a community, in spite of what Foucault might espouse.

This inclination to replace morals with market reasoning seems great on its face because markets "don't pass judgment on the preferences" that goods satisfy, and there are no presuppositions of value from third parties because “each party to a deal decides for himself or herself what value to place on the things being exchanged.” (Sandel, 2012, p. 14) Put succinctly, “markets do not wag fingers.” (Sandel, 2012, p. 14) Although, there are certainly downsides to this Faustian wager. As Michael Sandel, author of *What Money Can’t Buy,* writes:

Our reluctance to engage in moral and spiritual argument, together with our embrace of markets, has exacted a heavy price: it has drained public discourse of moral and civic energy and contributed to the technocratic, managerial politics that afflicts many societies today. A debate about the moral limits of markets would enable us to decide, as a society, where markets serve the public good and where they do not belong. (Sandel, 2012, p. 14)

The rest of my discussion is based entirely on this dichotomy between market reasoning and moral questions.

Chapter 2: The Ethics of Investing, Speculation, and Financial Markets

In Foucault's endorsement of market reasoning lies the presumption that morals are simply a means of control over the individual. However, this amoral stance does little to reflect the reality of investing and the limits that we would justifiably want to place on the market. While it may seem like a stretch to think of ways in which investments cross a line into a political domain, there are in fact numerous examples (besides the financial crisis) that shed light on why we should place limits on the market that are not just put in place to rid deficiencies in the marketplace but to make up for negative externalities that market reasoning cannot account for.

In the practice of making and setting standards for market reasoning and its moral limits, we are, in a sense, talking about the ethics of investing. However, the term "investing" is one that needs to be clarified before we can come to an understanding of what place we want it to have in our society and the limitations that we want to put on it. While calling a financial product an “investment” is common for nearly all forms of retail banking products today, are certain financial products deserving of the title of an investment? Furthermore, when can we make the distinction between what we consider to be investing versus speculation?

After making the distinction between investments and speculation, we will use certain examples of financial products to determine whether they fall under the umbrella of either category and whether they run into any moral limits. As such, the financial assets will delve into the profit motive of each investment, whether the profit motive comes into conflict with moral reasoning, and how market reasoning impacts civic and moral virtues by placing a sticker price through commodification.

Investing vs. Speculation

In the book *The Intelligent Investor* by Benjamin Graham, the first paragraph of the book defines the term “investor” by citing a 1934 textbook that declares: "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." (Graham, 1973, p. 18) According to the textbook, the primary tenets to determine a financial operation to be an investment is contingent upon its ability to protect the principle and a return that is deemed to be adequate compared to the risk associated with the product. Needless to say, not all of the financial products that are accessible to individuals and investment banks fall underneath the category of investment as given in the textbook criteria. However, financial publications and everyday discussions with ordinary people tend to make out every commodity that is traded on the market as an investment.

An example of such an investment is Bitcoin, which is generally talked about as an investment in the media; however, does it meet the premises needed to fit the definition from the textbook? One way to examine the first tenet, how well it promises safety of principle, is to figure out how volatile Bitcoin is in its listing price. A commodity that is deemed to be highly volatile is one that is characterized by wild degrees of change in its market value, whereas a financial product follows a relatively stable growth pattern in its value over time. Bitcoin, which is used to price plunges as much as $30,000 in a day (signifying a 30% loss of value on May 19, 2021), is considered a volatile commodity because of these large fluctuations in price. (Sigalos, 2021) If someone were to have bought a bitcoin at $90,000 on May 19 and checked his position before he went to bed to see his portfolio share of bitcoin to be $30,000 less than where it was valued earlier in the day, would he be likely to feel that his principle is safe? Most likely, he would not feel confident about Bitcoin maintaining the value of his principle. Therefore, placing money in Bitcoin should be thought of as speculation, not an investment.

Working off this definition, Benjamin Graham, the man whose investment strategy has been the foundation for financial moguls such as Warren Buffett, maintains that speculation is not something that must be avoided at all costs. Speculation is a permissible thing that an investor can do as long as he or she keeps three parameters in mind. "You must never delude yourself into thinking that you're investing when you're speculating. Speculating becomes mortally dangerous the moment you begin to take it seriously. You must put strict limits on the amount you are willing to wager." (Graham, 1973, p. 46) In this way, speculation is like going to a casino.

Speculative Bubbles

While there are surely investments, in the true sense, that have a fairly good reputation for stable returns over the long term, that does not always protect investors from speculative bubbles. What characterizes a speculative bubble is "a *large* and *long-*

lasting deviation of the price of some asset… from its *fundamental* value." (Blinder, 2013, p. 29) These can involve assets ranging from stocks to futures contracts, or even tangible assets such as a house or car.

When discussing the reference point in determining the occurrence of a bubble, the fundamentals are the value of dividends and capital gains to be expected in the future. A speculative bubble generally grows out of overestimating information in the market that positively affects the price of a financial commodity's fundamentals. For example, with the housing crisis, a bubble formed because investors believed that the large growth trend in mortgage-backed securities was because of positive trends in population growth or the interest rates on mortgages experiencing a decrease. With this, it becomes clear that the public finds it hard to spot bubbles, and when it becomes clear that there is a bubble, then it is generally too late for the ordinary investor to get out unscathed.

Just because the value of a financial asset goes up or down sharply in a short period of time, that does not mean that it should be considered too volatile to be considered an investment. For example, houses are still thought to be a worthwhile investment even though the Great Recession was kickstarted by a speculative bubble in the housing market. Instead, it must be clarified that speculative bubbles can affect any investment as long as the consensus around the price of a commodity outpaces the value of its fundamentals. In contrast, speculation is characterized as a financial operation that does not guarantee the safety of the principal or an adequate return.

Economic and Moral Reasoning: Ethics Case Studies

While Foucault was in favor of having market reasoning take the reins for government action because of his idea that economics is amoral, this does not always reflect the reality of the financial market. In this chapter, scenarios where morality and market reasoning intersect will be examined to determine whether economics can devalue nonmarket values, such as morals and civic virtues. All of these cases deal with real organizations, people, and programs.

Project Prevention, Drug Addicts, And Sterilization

Project Prevention is an organization founded by Barbara Harris that sought to address the issue of children going into the foster care system as the result of having parents who are drug addicts. According to its website, "more than half 55 percent – of the 16,000 children in foster care [in North Carolina], as of September 3, 2015, were taken from their homes because of parental drug use." (Project Prevention, 2021) However, many critics take issue with Project Prevention's means of achieving this goal.

To prevent children from being thrown into the foster care system because of parental drug addiction, Project Prevention pays drug addicts a sum of $300 for proof of sterilization or certain types of birth control that protect against pregnancy that are longer-term. It states that their main objective is to utilize their financial resources to "reduce the burden of this social problem on taxpayers, trim down social worker caseloads, and alleviate from our clients the burden of having children that will potentially be taken away." (Project Prevention, 2021) It is further claimed that "those resources we do have are spent to prevent a problem for $300 rather than paying millions after it happens in cost to care for a potentially damaged child." (Project Prevention, 2021) As of May 2021, Project Prevention has paid a total of 7,695 addicts to partake in long-term birth control since the organization's conception.

There are multiple arguments used against the organization's practice of paying victims of drug addiction not to procreate. First, critics say that "rather than help the recipients overcome their addiction… the money subsidizes it." (Sandel, 2012, p. 43) To this point, Barbara Harris admits that many of those who receive payments use the cash to purchase more drugs, but that she would rather enable their drug habit than allow another child to suffer the consequences of being born into a home scarred by addiction. (Sandel, 2012, p. 44) Despite some of these criticisms, it is unclear why any person who sees the free market as the most effective form of distributing goods would protest to the wager proposed by Project Prevention.

From the economic approach, it seems like this is simply an exchange between two parties that are entering into a voluntary agreement that provides utility to both sides. While it is true that, as some critics have pointed out, a party that is unduly influenced by drugs is not capable of consenting to such a contract, this only further proves that they are not equipped to be parents. As Barbara Harris points out, "if their judgment is that severely impaired…how can they possibly be expected to make sensible decisions about bearing and raising." (Sandel, 2012, p. 44) This objection to the deal backed by Project Prevention hints at two more criticisms that we might use to determine whether some transactions should be allowed to occur in the marketplace.

These two standpoints will be referred to as the coercion and bribery objections. The coercion objection is raised when a critic "worries that when a drug-addict woman agrees to be sterilized for money, she is not acting freely." (Sandel, 2012, p. 45) In addition, the bribery objection does not consider "the conditions under which a deal is made but about the nature of the good being bought and sold." (Sandel, 2012, p. 45) While it is customary to think of bribery as a shady deal that takes place between politicians or morally compromised businessmen, those are not necessary conditions to bribery. Instead, bribery can be defined in a broad sense as a transaction that corrupts the inherent value of a good by promoting the "buying and selling [of] something (a favorable verdict, say, or political influence) that should not be up for sale." (Sandel, 2012, p. 46) Corruption, in this sense, occurs when we treat a good or practice in a way that does not adequately reflect the value through the process of commodification. Put in this way, the issue of bribery might be brought against Project Prevention because its transaction with drug-addicted women equates the ability to procreate with a monetary value that does not correspond to the normative value that we typically place on parenthood.

Conversely, it could be argued that the transaction is morally repugnant because the monetary incentive makes it to where she must take the money. The drug addict may not be able to refuse the deal because she has trouble passing it up because of the addiction. Although one can argue with the degree of autonomy that both parties have in the transaction, this leads to a series of questions that must be asked to assess the validity of this objection. Namely, "under what conditions do market relations reflect freedom of choice, and under what conditions do they exert a kind of coercion?" (Sandel, 2012, p. 45)

Similarly, a number of questions need to be addressed to assess whether some transactions should be allowed to take place because of the bribery objection. For example, it could be argued that a political operative that is bribed to tip an election to a certain side is ultimately wrong because he is selling something that does not belong to him. For women, their ability to procreate is under her control, and she can decide whether she wishes to have children or not and to be a parent. Given this distinction, it is unclear whether certain circumstances in the Project Prevention case amount to bribery. If someone is selling something that is under her possession, then she could claim to have the right to sell it even if it is something affiliated with her capacity to procreate. The question we have to concern ourselves within this situation is: "Should we regard our bodies as possessions that we own and can use and dispose of as we please, or do some uses of our bodies amount to self-degradation?"

While it could be said that the context of the ethical dilemma is not applicable to the issues at the root of the financial crisis of 2008, the fundamental connection lies in the idea that financial incentives can improperly mischaracterize a good or service if not properly regulated to the degree to where we change the compensation structures of issues like how to allocate bonuses for serving customers in an investment bank and whether investment firms should be able to buy ratings of their securities from agencies such as Standard & Poor. In the chapter related to the causes of the financial crisis, the entanglement between moral and economic incentives will be brought to the forefront.

Fines, Fees, And Daycare Centers

While Project Prevention entices women to delay having children with positive incentives, corruption can also take place when negative incentives fail to adequately reflect the value of civic norms. As an example, assume that I, a college student with little to no money, decided to run a red light, and a camera at the intersection catches me. In a few days, I receive a citation in the mail that orders me to either appear in court or pay $235 in fines. (City of Houston, 2010) Due to the amount to the proportion of my income, this payment not only registers as a punishment for doing something wrong but will serve as an active deterrent when I come to the decision of whether to run a red light again.

Now, instead of having a broke college student serve as the subject of the example, let us consider how someone like Jeff Bezos would be affected in that scenario. Based on calculations from *The Independent*, Jeff Bezos' net worth increases by about $142,667 per minute. (O'Connell, 2021) Based on this, it is clear to see that a fine of $235 may not be a sufficient incentive to avoid running a red light for Mr. Bezos. If, for example, a chauffeur had him running late to a meeting, it may be more enticing for Mr. Bezos to tell his driver to run a red light and risk getting caught by a redlight camera than wait until the light turns green.

These different scenarios highlight the distinction between a fine and a fee. Whereas a fine is something imposed on an individual to signal that he or she has done something wrong and must therefore suffer monetary damages, a fee is a payment in exchange for doing a service. (Sandel, 2012, p. 65) In the example before, my reaction to the ticket would have been more in line with the concept of a fine because the weight of the monetary punishment felt heavier to me due to its comparison in size to my income. At the same time, the Bezos hypothetical treated the citation as a fee because the price of the ticket is a mere drop in the bucket compared to his net worth. Ultimately, the question of whether we treat something like a fine or a fee comes down to whether the negative incentive's value can effectively deter the intended group at which it is directed from a certain action or behavior. If the punishment does not fit the crime, so to speak, then it risks shifting attitudes toward promoting the behavior that is supposed to be deterred in the first place.

To lend credence to this statement, a field study by researchers Uri Gneezy and Aldo Rustichini into the effects that introducing a fine for late pickups at daycares in Israel provides intriguing results. In their method of conducting the study, the researchers examined ten daycare centers where six would be in the test group that implemented the fine of NIS 10 (about $3) for late pickups of the children. (Gneezy & Rustichini, 2000, p. 5) The hypothesis of the study was that when a fine would be imposed, late pickups in the experiment group would fall while the control group would remain consistent in its number of occurrences. After the fine would be lifted, the researchers expected that the number of late pickups for the experimental group would return back to normal levels. Instead, quite the opposite occurred.

Over a period of 20 weeks, the study monitored the existing behavior of both the experimental and control group before (first four weeks), during (12 weeks), and after (4 weeks) the fine was implemented. (Gneezy & Rustichini, 2000, p. 3) The first four weeks of the study had both the experimental and control group at about ten late arrivals on average per week. Once the fine was implemented, there was a rise in the average of late arrivals from 5 late arrivals in the fifth week to 20 late arrivals by the ninth week. The average of the control group remained level at around ten late pickups during the same period of time. After the fine was removed, the lower averages that were seen in the pretesting phase did not return in the experimental group. In fact, the test group's average remained steady at around the 20-late-pickups mark. While it is generally thought that an imposed fine, like the one that was implemented in this test, would decrease the number of tardy parents over the course of the study, it is evident that the fine changed the attitudes of the parents in a way that had the opposite effect.

In their interpretation of the results, the researchers propose the idea that the reason for the increase in the amount of relevant behavior after the fine was implemented could have occurred because the parents associated the fine as a price to pay for a commodity instead of a way to reprimand bad behavior. (Gneezy & Rustichini, 2000) Before the fine was implemented, parents would have viewed being tardy to pick up their child as an act that took advantage of a teacher's goodwill and generosity. This is emblematic of a viewpoint based on nonmarket values, such as civic duty and moral conscientiousness. However, after the fine was put in place, the parents' viewpoint changed to: "The teacher is taking care of the child in much the same way as she did earlier in the day. In fact, this activity has a price (which is called a 'fine'). Therefore, I can buy this service as much as needed." (Gneezy & Rustichini, 2000) This changing of perspective shows how the introduction of a fine can have a negative effect on altruistic behavior that is based on moral obligations and considerations for others.

However, the observed behavior in the study does not only suggest that the fine was the catalyst for the change in the behavior, but that "a fine is a price" that an individual considers before deciding how to act. As the hypothetical quote from a parent had stated, attaching a monetary value to the act of being late served as a way to commodify the time spent watching children after the designated pickup time. Due to the commodification, the extra time that was spent by the instructors to watch children past the specified time for pickup was seen as a fee associated with a service as opposed to a fine meant to deter parents from arriving late. As noted by the authors of the research article, "No guilt or shame (depending on the degree of internalization of the social norm) can be attached to the act of buying a commodity at will." (Gneezy & Rustichini, 2000, p. 14)

Thus, it can be observed through this study that, like in the example of the red-light scenario, the distinction between a fine and a fee can be blurred if a fine is not applied in a way where the damages incurred by the fine reinforce the idea that the action is frowned upon. Furthermore, once monetary incentives are introduced, "the old sense of responsibility [can be] difficult to revive" as evidenced by the fact that the number of late arrivals did not decrease after the fine was no longer enforced in the test group. (Sandel, 2012, p. 119) Fundamentally, the study demonstrates that a downside of economic reasoning is that "the introduction of market norms [displaces], or at least [dampens], moral and civic commitment." (Sandel, 2012, p. 118)

The Death Wish of Viaticals

Investments, like fines and fees, can also have an effect on the way certain aspects of life are considered when a profit incentive is placed on them. One industry that has made a name for itself based on the controversial way that it places a profit motive on death is the life settlement industry, formerly known as viaticals. Originally growing out of the beginnings of the AIDS crisis, these investments served as a way for life insurance holders who were diagnosed with AIDS to support themselves with income from investors via a secondary market in life insurance policies. (Lazarus, 2010, p. 253)

To illustrate how the investment works, imagine a hypothetical man, let us call him Jack, being diagnosed with AIDS in the early 1990s. During this time, HIV/AIDS was a death sentence: "half [of those diagnosed during this time died] within the first year after diagnosis, and eighty-five percent within three years." (Lazarus, 2010) Adding to the anxiety and fear that he would have felt, an HIV/AIDS diagnosis had affected not only an individual's health but his or her social standing as well, with many diagnoses being accompanied by being laid off, effectively taking away health insurance and other benefits. Thus, the HIV/AIDS diagnosis would be the final nail in the coffin for Jack's physical and financial wellbeing.

However, one way that Jack could make up for his lost income to deal with health and other basic expenses is to utilize his life insurance benefits, assuming he has one, through the viaticals market. The way the investment worked goes like this: Jack has a $1,000,000 life insurance policy and finds an investor who offers to give Jack $500,000 and agrees to pay for the premiums on the policy until he passes away. In exchange, the investor will become the primary beneficiary on the policy and will receive $1,000,000 when Jack dies in a year. Given the figures of the initial investment, the investor stands to make $500,000 in profit as a result of the investment (minus premium payments and other investment fees) and Jack would have received money to ensure that he could pay for end-of-life health services. Ultimately, this seems like trade with high utility for those parties involved, but the devil is in the details when considering the ethical criticisms that the viaticals market has faced.

Going back to the example with Jack, what would happen if the doctor told him that he had a life expectancy of one year after diagnosis but ended up living two years. If Jack still went through with dealing in the viaticals market, the investor would make less of a profit because of having to pay for an additional year of premiums. Therefore, it becomes clear that the investor has a vested interest in having the life insurance holder pass away as soon as possible to collect the largest amount of profit from the investment. (Sandel, 2012)

Acknowledging this ethical dilemma, brokers and other financial institutions that engaged with viaticals took active steps to try and distance the financial product from its morbid profit motive. In marketing the investment opportunity, companies took steps to improve their image by selling it as a socially conscious way to provide "those with terminal illness the resources to live out their last days in relative comfort and dignity." (Sandel, 2012, p. 137) This effort is even evident in the name of the investment, which is rooted in the Latin word "viaticum," referring to the last Eucharist or communion to dying members of the Catholic church. These surface-level marketing efforts did little to hide the moral issues underlying the investment strategy of viaticals, however.

While trying to maintain a clean image to the financial press, executives of high-level viatical companies sometimes slipped in sticking to their philanthropic verbiage of viaticals. William Scott Page, the president of a viatical investment venture, was quoted as saying, "There have been some phenomenal returns [with viaticals], and there have been some horror stories where people live longer… that's sort of the excitement of the viatical settlement. There is no exact science in predicting someone's death." (Page, 1998) However, the "excitement" that Mr. Page saw in viaticals also led to lawsuits where investors sued medical providers for giving life expectancy assessments to patients that did not reflect the reality in which the deal failed to "mature" as quickly as the investor had originally been led to believe. (Sandel, 2012, p. 138)

With this type of investment, the moral problem is the way in which it incentivizes and promotes certain attitudes about the death of a terminally ill patient.

While viaticals are certainly not the only kind of financial investment that deals with death, a common example being life insurance, the difference is in the structure of profit motive. For a life insurance company selling a term-life insurance policy, the insurance company has an interest in the longevity of the insured's life but in the opposite way that it does for viaticals. For term-life, the insurer makes the most profit if the insured outlives the term; for viaticals, however, "the sooner I die, the better." (Sandel, 2012, p. 139)

The question from this point is whether or not we should consider being critical of viaticals through this ethical lens. It is hard to deny that having a profit motive connected to death in the way that this particular investment does is at the very least morally questionable, even for the most enthusiastic free marketeer. Do viaticals pose a scenario where investments step outside the bounds of ethical ideals that we want to promote in society towards death? While this is a heavy topic to unload and may vary in answer from person to person, the best way to figure out the limits to place on markets is to have an open discussion where we delve into this very question. With viaticals, it becomes apparent that the line between economics and morality is not always as black and white as one would think. In delving into the causes of the financial crisis, it will become apparent that some of the investment strategies related to things like predatory lending practices and the incentive structures of financial analysts also changed the attitudes between financial experts and their customers. Like the viatical industry, there needs to be a discussion about the ethical ideals that we want to be embodied in the relationship between financial institutions and their customers.

Conclusion

As opposed to Foucault's insistence that economic reasoning should replace moral reasoning, the topics of this chapter highlight what an investment as well as what it is not (i.e., speculation) and how economic reasoning impacts moral reasoning in ways that many would view as morally abhorrent. As will be explored in the next chapters, there are similarities in the causes of the financial crisis and the corrosive effects that it had on nonmarket reasoning and values. Thus, the financial crisis of 2008 should not just be examined for its economic failings but its moral ones as well.

Chapter 3: Causes of the Financial Crisis- United States and Iceland

Introduction

Many analyses have been conducted by leading economic experts into the causes of the financial crisis of 2008; however, no one has analyzed the crisis by comparing the United States and Iceland. It may seem like an odd pairing at first: one tiny nation of roughly 350,000 and the other a global superpower that has nearly 1000 times the population. Plus, Iceland's banking system was nowhere as complex as the United States' with brokers dealing in derivatives, CDOs (Collateralized Debt Obligations), CDSs (Credit Default Swaps), and more products that contribute to the alphabet soup of financial jargon. The one common theme is the interplay between the economic crisis and its moral implications. Similar to what was discussed in the previous chapter on ethical considerations in investing, some of the root causes of the financial crisis are rooted in the perverse attitudes certain incentive structures were built around home lending practices, profiting from the complexity of financial products, lack of regulatory oversight, and compensation structures of financial analysts.

Underlying all of the causes of the financial crisis for both the United States and Iceland is a common theme that ambition is driven by trying to attain ever greater returns without respect to market fundamentals. Thus, the point of this chapter is that the causes of the crisis were not just about the surface-level housing crisis but about the rotten roots at the core of the financial system that cherished speculation over investments, incentivized ethically perverse profits, and promoted a fee (not a fine) mentality for losses generated by their speculation.

Causes of the Financial Crisis – The United States

Extreme Leverage in Investments

One of the keys to understanding the financial crisis of 2008 is the exorbitant use of leverage by consumers to purchase investments such as homes. Leverage is a term used to describe "the use of borrowed funds to purchase assets," i.e., credit. (Blinder, 2013, p. 48) Leverage itself is neither inherently bad nor good, but the way in which it is used ultimately determines whether or not it is a valuable financial tool.

For an example of both the benefits and pitfalls of leverage, take two hypothetical investors, Jennifer and Austin, who both invest in a bond for one year. Jennifer, who is a defensive investor, puts $100,000 of her own money into the investment. As a result, when she cashes out the bond in a year, she collects her principal as well as $6,000 in interest if the stated interest rate was 6 percent. Jennifer is now sitting comfortably with a profit of $6,000 from her investment.

Austin's approach to this same investment is different in that he, unlike Jennifer, is not as hesitant to use leverage to attempt to amplify his earnings. Austin decides that he will take out a loan from the bank of $900,000 while also utilizing $100,000 of his own money to purchase the same stock that Jennifer purchased for $1,000,000. This financial maneuver means that Austin has now leveraged his investment position by ten times. At the end of the year, Austin takes out his original principle with the addition of interest, a total of $1,060,000. Once he receives the money, he will have to repay the bank loan; the interest on the loan is 4%, which will cost him $936,000. However, the remaining profit for the investment will be $124,000, for a rate of return of 24%, which was four times as high as Jennifer's profit.

However, now assume that the bond loses 5 percent of its value during the holding period and that Jane and Austin have to sell before the end of the year. Jane would collect $95,000 with $6,000 in interest, which would add up to $101,000 for her rate of return. Subtracting her original principle of $100,000, her total return would be 1 percent or $1,000. Conversely, Austin's payout is now $950,000 with the addition of $60,000 in interest, coming out to $1,010,000. However, he still has to pay the bank back $936,000, meaning that he will now only recoup $74,000 of his original $100,000 investment, making for a negative rate of return of 26% (a loss of $26,000). With this example, it is clear to see that leverage is not a bad financial tool in itself, but that, just as it has the potential to amplify returns, it also has the potential to multiply losses.

The use of leverage to buy homes during the prelude to the financial crisis was like Austin's leverage on steroids. With older financial models encouraging new homeowners to buy homes with at least 20 percent down, leverage of 5-to-1, many homeowners began to put down as little as 5 percent or less. (Blinder, 2013, p. 47) This would mean that if the house that was purchased went down in value by as little as 5 percent, the homeowners would be underwater, meaning they would lose all equity in the house. (Blinder, 2013, p. 47) It was even common in some real estate transactions for the owner to borrow the entire principle via other loans or an additional mortgage. (Blinder, 2013, p. 47) This would translate to any loss of value in the property being a loss for the owner because there was no owner's equity to begin with. This type of approach to home buying does not make the home buyer an investor but rather a speculator since it is essentially a bet that the positive trend of housing prices will continue into the future. (Blinder, 2013, p. 49)

To further reinforce the position that borrowing and leverage were skyrocketing in the lead-up to the crisis, from the period of 2000 to 2008, total household debt (mortgage plus personal debt) "rose from about 100 percent of GDP to about 140 percent in only eight years." (Blinder, 2013, p. 49) The increase in the amount of credit for each household reflects a society where debt is encouraged and interdependency to where households become engrossed in a pattern of behavior where living beyond one's means is encouraged.

While there are certainly ways where leverage can be used as a worthwhile financial maneuver, as seen with the example of Jennifer and Austin, it should be made clear that such use of credit is speculative and is not indicative of being called an investment when excessive leverage is being used. It is also important to reflect on how we view such financial decisions when we consider how we invest in financial products such as homes. While homeownership is generally considered to be the largest share of an average person's net worth and a pathway to building generational wealth, not everyone should be encouraged to buy a home even if the housing market seems too good to fail.

To assume that the same financial performance for the value of goodwill continues to grow exponentially into the future is as far away as one can get from market value fundamentals. With this type of investment reasoning, it's no wonder that a speculation bubble formed in the housing market. To assume, however, that people taking out large amounts of credit on their own to buy houses they could not afford was the sole cause of the financial crisis is an oversimplification.

While the issue of mortgage default was the catalyst to the financial crisis, the market amplified the issue to the tremendous heights of international financial turmoil through the introduction of mortgage-backed securities. These securities essentially acted as bonds and were bought by many investment firms because many saw the risk of mortgage default as extraordinarily low compared to other types of investments, with many being rated as highly as US Treasury bonds. (Blinder, 2013, p. 41) Like the owners of houses that purchased homes with large amounts of leverage, bond purchasers made the mistake of valuing the securitization market of mortgages as a group of investments that were so safe as to never default. Likewise, "underestimating the risk of default is therefore tantamount to overestimating the value of the bond." (Blinder, 2013, p. 41) Thus, by not adequately evaluating the behavior of homebuyers and mortgages, investors believed that putting their mortgages in mortgage-backed securities was an investment when it was really based on speculation.

How did the financial sector manage to fall into the trap of burying their heads in the sand regarding the impending burst of the housing bubble? While it could certainly be said that other causes were purely economic circumstances, I do not hold this as the true answer to the causes of the crisis. Incentive structures and unethical practices that put greed ahead of the fiduciary responsibility of financial analysts to their investors played a predominant, if not the majority, part.

Predatory Practices in Subprime Lending

While there are certainly nontraditional aspiring homeowners who benefit from being able to utilize subprime home loans (reserved for credit applicants with FICO scores of 620 or below), there were also numerous prospective homeowners who fell prey to predatory mortgage lenders. The issues of these predatory practices come from an incentive structure in which brokers, not bankers, created the mortgage for the consumer in the hopes of selling it off to a GSE (Government Sponsored Enterprise) like Fannie Mae or Freddie Mac to make their commissions. Thus, there was no skin in the game for the mortgage broker to ensure that they were making sure that the debtor could make adequate payment on the mortgage to prevent default. (Seiler, 2014, p. 207)

Take, for example, the situation that befell Alberto and Rosa Ramirez, a married couple who were both strawberry pickers in California with an annual income of $12,000 to $15,000 dollars. (Blinder, 2013, p. 69) With the help of a sleazy real estate agent, who likely took advantage of their lack of fluency in English, the Ramirezes acquired a $720,000 mortgage with New Century Financial Corporation. How could someone with an annual income that is below 2 percent of their home's worth get approved for such a mortgage? With a little creative problem solving, the agent listing their income as $12,000 *per month* and their careers as "field technicians," and the unsuspecting Ramirezes were placed into a home that could have made them believe they had achieved the American Dream without realizing that they had just entered into a future financial nightmare. (Blinder, 2013, p. 69)

The case of the Ramirezes was likely not an outlier incident of unethical lending practices. The rate of subprime lending also increased greatly during the lead-up to the financial crisis. "Subprime mortgages were a mere $35 billion (under 5 percent of total originations) in 1994 but reached a stunning $625 billion (20 percent of the total) in 2005 – almost an eighteen-fold increase in just eleven years." (Blinder, 2013, p. 70) Is it merely a coincidence that a large influx of people with under-par FICO scores but who were otherwise creditworthy just magically started getting an interest in buying homes? Or was there a fall in standards for writing and approving mortgages? If the previous case of the Ramirezes is any indication, it seems as though the latter is more probable than the former.

While the Ramirezes were given a mortgage based on false pretenses that their income was higher (what has become known as a liar loan), there were also a variety of other loans that were used in mortgage brokers to make as many mortgages as possible. Such loan types include low-doc ("loan files with little documentation"), no-doc ("files with no documentation at all"), and even NINJA loans – "granted to people with no income, no jobs, and no assets." (Blinder, 2013, p. 70) To further support the idea that a rise in subprime mortgages was due to falling standards in the pursuit of greed, "it has been estimated that almost one third of all subprime were of either the low-doc or no-doc variety." (Blinder, 2013, p. 70)

How could any responsible banker or lender ever grant a mortgage without verifying that the prospective homebuyer was purchasing a home within their financial means? The issue comes from the fact that mortgage brokers were enticed by a perverse profit motive, giving more mortgages to companies for the securitization of them into mortgage-backed securities that would serve as the basis for the house of cards that contributed to the financial crisis. Predatory lending practices encouraged a short-term model of thinking that had mortgage brokers concerned about making their next commission rather than caring about whether the debtor could afford the financial demands of the mortgage for long-term financial security. While there has been more emphasis placed on the causes of the financial crisis related to the advanced financial products that were built off the backs of these dodgy mortgages, the question still stands as one that brings ethical considerations about profit incentives and the corrosive effects that economic factors can have on ethical considerations.

The Unnecessary Complexity of Mortgage-Backed Securities

As hinted in the last chapter, mortgage brokers were incentivized by financial institutions that took mortgages that could be transformed into financial products such as bonds and derivatives. These securitizations, however, were more than just bonds that were valued on the basis of the underlying mortgages that backed them. Instead, Wall Street took mortgages off the balance sheets of mortgage brokers to create extremely complex securities that were financially engineered to be as ambiguous as possible to enable monopolization and to play on the gullibility of investors to make a profit.

As Alan S. Blinder details in his book, *When the Music Stopped*, there was a complex web of securities that played into the crisis. (Blinder, 2013, p. 77) First, the originator of the mortgage, the broker, would sell his mortgage to a securitizer, such as Freddie Mac or Fannie Mae, which would then convert it into a residential mortgage-backed security. Then, those securities would join a host of other securities, known as asset-backed securities, to be sold as asset-backed securities. Asset-backed securities included products that were backed in value by other securities such as credit cards, student loans, auto loans, and commercial and personal mortgages loans. From there, the residential mortgages would be divided into pools that were meant to classify the riskiness of each group that would come to then become a collateralized debt obligation, a CDO. These CDOs were labeled as senior (extremely safe investment), mezzanine (not as safe as senior but also not junk), and equity (all the junk mortgages).

Following this, the CDOs would either be sold to consumers as is or restructured into new CDOs, referred to as CDO squared and CDO cubed, to use financial magic to further obscure the bad mortgages into securitizations that would be more attractive to sell. This is in spite of the fact that the riskiest mortgages usually made the majority of the new CDOs. In addition, investors could also purchase insurance on the CDO, known as a credit default swap (CDS), through insurance companies like AIG that would theoretically cover the investor if a CDO defaulted, which would be triggered by the default of a large portion of mortgages that were built into the CDOs. Couple this with the asset-backed commercial paper (ABCP) market that was used for banks that were essentially short-term loans that were backed by residential mortgages as collateral. (Blinder, 2013)

Why build in all this complexity to mortgage-backed securities? It is because "complexity and opacity are potential sources of huge profit." (Blinder, 2013, p. 77) As Blinder points out, "the more complex and customized the security, the harder it is to comparison shop for the best price." (Blinder, 2013, p. 77) Furthermore, if only one investment company offers a specific product, then it effectively holds a monopoly on it and can set the price to be whatever it would like it to be despite the actual value of the product. Compare the complicated CDO to a futures contract on a stock (a much more common example of a financial product that is easier to understand). Where an investor looking for a futures contract can shop around to find which one he or she will inevitably purchase, a buyer of a complicated CDO has no reference point to determine if he or she is receiving a fair deal on the product in a way that reflects the value of the commodity. Thus, more complexity equals more profit.

The financial analysts who were selling these overly complex financial products knew they were taking advantage of ignorant customers, too. As Blinder also notes:

When Goldman Sachs' infamous trader, the 'Fabulous' (by his own assessment) Fabrice Tourre, helped [his hedge fund]… bet against especially poor subprime mortgages by designing made to order synthetic CDO, whom do you think that he envisioned as the buyers? One of Tourre's own answers was: Belgian widows and orphans… In a widely quoted email, he bragged to his girlfriend that he was the 'only potential survivor, the fabulous Fab… standing in the middle of all these complex, highly levered, exotic trades he created without necessarily understanding all the implications of those monstrosities.'… he [also] added that he was 'not feeling too guilty about this.' (Blinder, 2013, p. 78)

The problem with this type of rationale is easy to spot for the consumer. How can any investor truly expect to trust a financial trader that tries so blatantly to deceive customers? Furthermore, it should also be noted that Tourre was put on paid leave from Goldman in the aftermath of the crisis and that the Justice Department decided not to file charges against the "Fabulous" in August 2012. (Blinder, 2013, p. 78)

The entire endeavor of profiting from the hoodwinking of investors is one that undermines the backbone of the financial industry, that being security. While Wall Street firms can make all the complex financial products to their heart's content, those who are left at risk are the customers who thought that they could trust those analysts who sold them those products. Should complexity prevail at the expense of the interest of the everyday investor? No, complexity should not prevail because of the fiduciary obligations of financial institutions to their customers. To deny such a responsibility makes a financial analyst more like a snake oil salesman than anything else.

The Perverse Compensation Structures of Rating Agencies

As mentioned in the previous chapter, one of the hidden issues in the complex web of mortgage-backed securities was the unreliability and inaccuracy of bond ratings of residential mortgage-backed securities that were incorporated into CDOs. The most coveted of ratings, the almighty AAA rating, was given out way too much in retrospect. To put this into perspective, "only six blue-chip American corporations – names like GE, Johnson & Johnson, and Exxon Mobil – and only six of the fifty states merited the… Triple-A credit rating." The problem with grading too many MBSs as AAA was that a plethora of securities was advertised as less risky than they actually were in reality. While the company line of many rating agencies, such as Moody's and Standard & Poor's, was pure ignorance, another issue of incentives is widely viewed as the main culprit.

The root issue with the business structure of the rating agencies is that their appraisals were subsidized by the securitizers. This had the effect of having rating agencies catering to their customers by giving their securities higher ratings than they might have otherwise deserved based on the actual fragility of the assets in question. Would it be considered a reasonable compensation structure for teachers to be compensated by their students for every grade that they receive? No, because it puts the teacher in a position where they can no longer be counted on to be nonbiased since their compensation relies directly on the customer, in this instance, the students. A tendency for any server is to want to please their customers for a higher payout. Thus, such a compensation structure corrupts the very relationship between the intended impartiality between teacher and student. In this same way, the relationship between the rating agency and securitizer is also corrupted to the extent to where any rating should be viewed with skepticism and suspicion.

Another problem with this compensation structure was that the practice of securitizers shopping around for ratings became common. For example, if Moody's gave one security an AA rating but Standard & Poor's gave the security an AAA rating, then which agency do you think the securitizer would pay for the appraisal? Such practices further undermine the legitimacy of rating agencies and their credibility to the investing public.

Finally, the larger issue within this perverse compensation structure is that, rather than conducting research on their own, many investors and analysts rely on the rating agencies to determine the soundness and risk of an investment. Such a reliance meant that investors really had no idea of how to value of the fundamentals in the securities that they were purchasing and guaranteed that there would be an economic panic once those investments began to flounder. Once investors saw the blood in the water with investments that once held the lucrative triple-A rating, how could they trust the security of any of the other positions that they held in the market? This erosion of trust between the appraisals of rating agencies and the investing public was one of the central causes for the confusion at the beginning of the financial crisis.

As Bob Steel, a Goldman Sachs alumnus at the Treasury Department during the financial crisis, once said when comparing mad cow disease to the behavior of markets: "The disease may infect only a tiny portion of beef on the market, but the infection is so frightening that consumers shun all beef." (Blinder, 2013, p. 79) In a similar sense, once the market saw that even the investments that were deemed to be the most secure were falling into default, the rest of the market became suspect to what else may be lurking around the corner. Thus, the relationship between the investor and the rating agency was also corrupted, like that of the mortgage broker and financial analyst, due to profit motives that put money ahead of the financial wellbeing of the investor.

Conclusion: Systems of Compensation and Moral Principles

In all of the causes of the financial crisis that were examined in this chapter, a pattern of putting profits before customers became the norm that eventually led to the financial calamities of 2008. Through this lens, it becomes clear that while economics can be used to great effect in the distribution of goods, there must also be an evaluation of the means and ends of market transactions. The business structures that led mortgage brokers to go for quantity over quality for mortgage applications, the financial analyst's mission to establish more complexity in the market at the expense of consumer protection, and the rating agencies allowing the investments firms to pick and choose their own grades on securities led to a market where financial products were not traded equally because of the fact that, for the profits to keep rolling in, the investor had to be kept in the dark.

Is the scenario that was just described reflective of a just or equal society where goods are traded on an equal and fair basis between economic actors? No, like with the example of viaticals, there are some profit motives that alter the relational structures between the parties involved in the financial transaction. While those in the mortgage broker offices, investment firms, or regulatory agencies were not put in a place where they were encouraged to hope that someone died soon, like with the viaticals market, there was certainly a corruption of values between profit and fiduciary responsibility.

Causes of the Financial Crisis – Iceland

As noted before, there are differences in the causes of the economic downturn that occurred in 2008 between the United States and Iceland. While there is a definite disparity in comparison between the population of the US and Iceland, that may ultimately make for a better comparison where Iceland serves as a small-scale version of the US model. While a large number of actors in the financial sector contributed to the issue of placing accountability for the recession, economists such as "Vilhjalmur Bjarnason calculates that Iceland's meltdown was caused by a mere thirty people: the core of the country's decision-making elite." (Boyes, 2009, p. 167) From this perspective, the Icelandic causes of market manipulation, risky credit lending, and politicization of the free-market movement in the 1990s will be examined in comparison to the United States.

The Politicization of Financial Markets

At the root of the issues with the financial sector in Iceland that led up to the financial crisis was the cozy relationship between David Oddsson, the Icelandic prime minister who oversaw the deregulation of the financial sector in the 1990s, and the big banks of Iceland. Oddsson, a fierce supporter of neoliberal ideology, began to convert the small nation that was generally built around a strong sense of collectivism to the belief that Iceland had become a nanny state. This analogy was not hard to make given such regulations in the Icelandic community as "beer [being] banned until 1989 [and] television shut[ing] down on Thursdays to give families time to talk, sing, and read books." (Boyes, 2009, p. 600) All Oddsson had to do was convince the Icelandic people that the government had become too big and needed to deregulate itself to make way for more political freedom among the population.

Once that was in place, he began the next phase of his plan, which was to sell off the shares of the central government's stake in the financial sector to the highest bidder. However, this process was rigged to give more power to Oddsson's cronies under the guise of liberalizing the financial market in Iceland. To illustrate this point, look no further than the 2002 sale of government stock in two of Iceland's biggest banks, Landsbanki and Bunadarbanki. To live up to Oddsson's free-market creed that "ownership should be spread as widely as possible within the island," the Executive Committee on Privatization stated that it would sell off its ownership in the banks in a phased manner that would allow for the banks to become publicly owned instead of their previously state-owned status. (Boyes, 2009, p. 792) However, after a few phased selloffs of the government stock, Oddsson intervened in the process to put the vast majority of controlling shares left in the banks up for sale. (Boyes, 2009, p. 815) The result was, after a brief announcement and a selection committee that weeded out politically undesirable buyers, the ownership of the banks fell to groups headed by Olafur Olafsson and Bjoergolfur Gudmundsson. (Boyes, 2009, p. 807) Both of them were political puppets that were affiliated with the Independence (headed by Oddsson) and Progressive political parties in Iceland. (Boyes, 2009, p. 807) Thus, under this leadership, "the two banks… became party funding machines, ensuring a lack of curiosity about their activities from the regulators, from parliament, and from government." (Boyes, 2009, p. 798)

Like the United States, Iceland's government would fail to realize the issues within the banking sector because of regulatory issues. However, the political corruption that was present in the Icelandic financial system was more akin to an Italian mob operation than anything that the US saw in its crisis. Thus, as Robert Boyes notes in his book *Meltdown Iceland*, "Regulators and monitors failed Iceland in a spectacular way; there was an institutional breakdown, an utter dereliction of duty on the part of a political class that had become intimately intertwined with big business and bankers." (Boyes, 2009, p. 126) This arrangement of political corruption entailed that the Icelandic government would stay out of the management of its top banks as long as they continued to perform well in the eyes of the market. Not unlike the US, the basis of this relationship meant that corporate interests would prevail over consumer protection due to regulators being asleep at the wheel, thereby allowing the banks to stray away from their fiduciary responsibility.

Market Manipulation and Risky Lending

The crux of the issue that set off the financial crisis in Iceland, unlike the complicated system in the United States, was a large amount of borrowing by the Icelandic public. However, while other countries certainly experienced record highs in the debt-to-income ratio of individual citizens, what makes the issue especially troubling in the Icelandic case was that borrowing on credit from the bank was encouraged because "the debt was supported by high stock prices." (Boyes, 2009, p. 140) Unknown to the public, though, was that the stock prices were falsely inflated due to the banks essentially buying their own shares through lending money to investors that would immediately put the money back through the equity line. (Gunnarsson & Stefansson, 2020, p. 449)

The process of market manipulation followed a series of steps that inevitably led to a reckless amount of systematic risk to the financial system that was created by some of the biggest banks in Iceland – Landsbanki, Kaupthing (formerly known as Bunadarbanki), and Glitnir. Firstly, the banks went into the regulated market to buy their own shares but could not prop up the value of the stocks through this channel because there was a limit of 10 percent of stock that they could purchase themselves. (Gunnarsson & Stefansson, 2020, p. 449) To evade this rule and continue to manipulate their stock price, a buyer was found that could be lent money to repurchase the stock for the company to maintain the share price without directly implicating the company in buying back its own stock. (Gunnarsson & Stefansson, 2020, p. 449) A loan to these buyers had to be made because it was otherwise extremely difficult to find a buyer of such means as to purchase the stock outright without from the banks. (Gunnarsson & Stefansson, 2020, p. 449) Therefore, loans associated with this market maneuvering were often done with "unusual terms, for example, by extending loans secured only by the shares themselves to a limited liability company with no assets." (Gunnarsson & Stefansson, 2020, p. 449)

The scheme that these banks created constituted market manipulation because they knew that the underlying fundamentals, the expected capital gains and dividend yield, were not equal to the value expressed in the market. To combat the speculative bubble from bursting and devaluing the stock, banks in the Icelandic financial sector propped up the market price by making extraordinarily risky loans that would implode if and when a financial crisis occurred. It was an inevitability that the stock would crash if the stocks in the Icelandic financial sector crashed because "lending to borrowers whose only substantial assets were often [those] same shares" that they intended to buy meant that the stock price was highly leveraged. As with homeowners in the United States, when an investment is made with high amounts of leverage, the investor becomes extremely susceptible to downturns in the market because gains and losses are magnified through the use of credit to purchase investments/speculate.

Ultimately, the market manipulation by the banks was used to keep up the façade that the financial sector was booming and that citizens of Iceland could borrow to their heart's content. Yet, this inevitably led to creating a stock bubble that would be burst from activities an ocean away. Who knew that we would live in a world where home foreclosures on the other side of the globe would cause enough insecurity in the market to topple an economy a world away? With the little momentum it took to burst Iceland's dreams of becoming the next financial powerhouse of Europe, "all three of Iceland's big banks wound up being nationalized, the Icelandic krona fell through the floor, the stock market lost 90 percent of its value, and Iceland's economy sank into a deep recession." (Blinder, 2013, p. 170)

Conclusion – Connecting the US and Icelandic Causes

While the causes of both the Icelandic and US responses are quite different in the complexity and mechanisms that created the speculative bubble, the most prominent connection between them is that both of their financial institutions participated in practices that underestimated the fundamental value of commodities in a way that corrupted the value of investments to turn them into speculation. In the case of the United States, the market was manipulated by a series of actions from mortgage brokers, financial analysts, and regulatory agencies. For Iceland, the corruption was concentrated in the political connections between the banks and political parties as well as their scheme to manipulate the price of their stock through purchasing it via third parties that were loaned the money for the purchase.

A closer comparison can be made between the rating agencies in the United States and the repudiation of responsible oversight in the government of Iceland. Like the rating agencies, the government of Iceland had a vested interest in making sure that the banks and investment firms in Iceland stayed afloat, even if that meant turning a blind eye to the true value of the entities under their supervision. The profit motive structure of both of these relationships led to the corruption of the values that are supposed to be underlying the relation between regulatory bodies and the financial companies they are supposed to monitor.

While the bubbles of both countries were created by the market value of the commodities not reflecting the amount of leverage and risk that was embedded within them, the buck stopped at the gatekeepers who investors trusted to protect them from speculative positions that created systematic risk within the stock markets of both countries. While both countries had these similarities in place, there is a wide divergence between how they responded to the crisis. In the next chapter, the US response will be evaluated for its failure to hold the financial actors that were responsible for the financial crisis accountable for their choices.

Chapter 4: The Failed Response: The United States and TARP

Introduction

Following the day that Lehman Brothers failed, the United States' stock market went into free fall due to investors feeling unsure about the market's future because of the unexpected closure of one of the most prominent investment firms on Wall Street. What was particularly odd is that the Federal Reserve pulled out all the stops to save Bear Stearns, another investment firm that was barely treading water, by facilitating its acquisition into JP Morgan Chase. Due to how they treated the Bear Stearns situation, many market analysts believed that the Federal Reserve or the Treasury would step in to do the same with Lehman Brothers. On September 15, 2008, those beliefs were proven to be just that, beliefs. Lehman Brothers would go on to declare bankruptcy, and the market would go into freefall as investors feared the uncertainty in the air.

With the collapse of the stock market, it also became clear that the mortgage-backed securities that held coveted risk ratings were not even worth their weight in paper. As analysts became aware of this fact, the next issue to confront was that banks now held these securities in the form of commercial paper that was backed by residential mortgages. With many of these same mortgages defaulting, the short-term loans issued with commercial paper became worthless, and the threat of numerous banks facing insolvency became real. To combat this, the Treasury Department, under Secretary Hank Paulson, deployed the Troubled Assets Relief Program (TARP) to combat the crisis.

While the program was ultimately successful from a technical perspective, proving to not only be effective in solving the dire short-term issues with the financial crisis but also in ending up making money, the general public still holds negative views on TARP. For example, according to Pew research; "A Feb. 2012 survey found that 52% of Americans thought bailing out the banks through the Troubled Asset Relief Program (TARP) was the wrong thing to do, while 39% supported the action. That was a big turnaround from 2008 when the crisis hit in 2008, and 57% had said TARP was the right thing to do." (Drake, 2013) So, if this program was so effective, then why has it garnered such unpopular opinions? The reasons for the public perception of TARP have more to do with what the program and presidential administrations did not solve with its implementation. Specifically, Treasury Secretary Hank Paulson mishandled the marketing of the program as it moved through legislation, and it failed to address executive compensation in connection to accepting government funds.

The Issues with TARP's Initial Proposal

After the averted crisis from Bear Stearns, the Treasury Department decided to draft a contingency plan for if and when a financial meltdown occurred. Out of this concern, a memo was created that would become the basis for the TARP program. As Alan S. Blinder details in his book, *After the Music Stopped,* the memo contained four basic tenets that would go on to define the legislation for TARP. These policy ideas ranged from:

1. Buying toxic assets – which was the suggestion the Treasury heard most often from market participants, and was the one that would later give the TARP its name;
2. Guarantee the assets rather than buy them – which was an option reluctantly included, under political duress, in the ultimate legislation;
3. Inject capital directly into banks by buying their shares – which would become the TARP's signature program; and
4. Refinance home mortgages into loans guaranteed by the government – something that was not done with TARP money to any great extent. (Blinder, 2013, p. 179)

Following the actions by the government to essentially nationalize AIG, an extremely large insurance firm that held the majority of credit default swaps on mortgage-backed securities and derivatives, the Treasury Department determined it was time to break the glass and roll out the plan it had outlined within the memo. While, up to this point, the Federal Reserve had done a lot of the heavy lifting in intervening to save Bear Stearns and AIG, both Paulson and Ben Bernanke (then the head of the Federal Reserve) agreed that the plan needed to go through the traditional structure of Congress, rather than be implemented through the apolitical institution of the Federal Reserve. However, with some policy options that were embedded within the memo, specifically the option to buy shares of banks to bolster their equity, the Treasury Department had to act with caution to ensure that the solutions in the proposed program did not spook investors or draw the ire of both Republicans and Democrats.

If the option to buy shares of stock from the banks was announced, Paulson worried that it would scare off investors who would fear nationalization of the banks and their stock, Republican backlash that would surely decry the actions as socialism, and Democrats who would view these capital injections as bailing out the financial actors responsible for the crisis. With all of these concerns in mind, the Treasury made sure to keep the language in the proposal for TARP as broad as possible to allow capital injections (purchases of stock) without actually announcing its intentions to do so in public. Thus, when Paulson and Bernanke went to Capitol Hill to ask Congress to approve TARP, they did so under the guise that the program would only buy toxic assets off the balance sheets of banks and not purchase stock. Such actions would go on to label TARP as ultimately a bait and switch scheme in the eyes of the public. (Blinder, 2013)

After rounds of political maneuvers and talks with politicians to whip votes for TARP, the first draft of Paulson's TARP plan was announced and made available online. Within its three-page outline, many bombshells were dropped that were met by public outrage and concern that the Treasury was attempting to circumvent constitutional authority. Such accusations were primarily levied at Section 8 of the proposal, which explicitly stated that:

Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency. (Blinder, 2013, p. 185)

The section was essentially saying that the program's spending of its funds (it originally asked for $700,000,000,000) could not be reviewed by courts and could act with impunity in its distribution. With such a provision in the proposal, many found this request from Paulson to be at least disrespectful and at most an impeachable offense.

Following the proposal's release to the public, a media firestorm hit Paulson's Treasury department. "Committee chairman Chris Dodd (D-CT), who supported the basic TARP idea, snapped that 'this proposal is stunning and unprecedented in its scope and lack of detail… It is not just our economy at risk, but our Constitution as well.'" (Blinder, 2013, p. 187) The three pages were also lampooned by the *New York Times* by saying TARP stood for "Total Abdication of Responsibility to the Public." (Blinder, 2013, p. 187) As publications such as *Newsweek* also went on to call Secretary Paulson "King Henry," it became clear that many saw this legislation proposal outline as an affront to the very ideas that the country stood for and rejected it from the start.

TARP, Executive Compensation, and Stigma

In the wake of the public relations nightmare that came out of the infamous three-page memo, Congress went back to the drawing board to rework the terms and conditions of the program and sought to establish requirements of lending for financial institutions to receive federal funds through TARP. Such conversations led prominent

Democrats to demand that limits on executive compensation be tied to accepting taxpayer money. The support from Democrats was needed at this point because TARP was already hotly contested by the Republican party due to the nature of spending it was trying to make and the active role it was sure to place the government in the market. Therefore, Paulson and Bernanke knew that the only way to garner enough support for the bill to pass was to reach across the aisle.

The primary issue with attaining Democrat support was Paulson and Bernanke's idea that attaching executive compensation limits would stigmatize prospective participants for the program not to take the capital injections. From the Democrat's side, it seemed like a fairly understandable request given that the government was doing these financial institutions a favor for buying toxic assets off their balance sheets. Ultimately, it just seemed fair to have some strings attached to how the banks would use the money afforded to them through TARP.

Paulson, however, repeatedly rejected the idea due to the perceived threat that it might further hurt the stock prices of those receiving the funds. While it is understandable to fear that those firms that would receive money would be viewed weaker than others, the worry was severely misplaced because signaling is only a concern when dealing with unobservable differences across markets. For example, when an employer is looking to hire someone for a new position in their company, they are looking for particular skill sets that make people good employees. Yet, the trouble with hiring comes from the fact that there is no way to empirically verify that a prospective candidate will be an exceptional employee without the use of signaling. Due to this, “employers will then prefer applicants with some observable characteristics that signal the presence of these desirable traits.” (Blinder, 2013, p. 190) Such traits can be positive signals, like a college degree, or negative signals, like an extensive police record. In this case, Paulson worried that accepting TARP funds would be considered a negative signal to investors of those companies that accepted government funds.

However, this argument only works if it is not readily apparent as to who are the current winners and losers in the market. As Blinder notes:

> Markets had numerous ways to distinguish between strong and weak banks: stock prices, credit ratings, CDS spreads, analyst’s reports, market chatter, and so on. No one had to watch TARP take-up rates to judge whether JP Morgan Chase was stronger or weaker than Citigroup, or whether Goldman Sachs was stronger than Morgan Stanley. And, if they needed any help, the strong banks were eager to provide it. To take one concrete example, Goldman was not worrying about stigmatizing itself when it became the first user of the FDIC’s guarantee program for corporate debt. Goldman was the fastest antelope in the herd, and everyone knew it. (Blinder, 2013)

Given this, it is clear that limitations on executive pay could have been placed without fear that investors would have revolted against organizations that took TARP funds.

Despite this, Paulson got his wish because, while some restrictions were put on participants who accepted TARP funds, they were ultimately toothless. In the final bill for TARP, “the law disallowed golden parachutes and capped severance payments at three times base salary… [and] banned giving top executives pay incentives that encouraged ‘unnecessary and excessive risks,’ but it left that determination to corporate boards, not to the Treasury.” (Blinder, 2013, p. 191) With such lax restrictions, there was hardly any risk that came with accepting TARP money and surely solved the signaling concerns of the Treasury, even though such concerns were unfounded.

While signaling that concerns for the banks might have been solved, the relaxed stance towards reckless banks and the government’s role in disciplining them stigmatized the public perception of the TARP program. From the perspective of the body politic, the message that was being sent from Washington D.C. was that taxpayers would bail banks out in the end, even if the financial crisis occurred because of their greed. Especially with the added bonus that many of the CEOs who received funds from the program were some of Secretary Paulson’s colleagues when he was CEO of Goldman Sachs, it was hard to resist making the connection that Paulson was more interested in helping out his Wall Street friends rather than helping ordinary Americans.

Conclusion

The effect of these missteps from the Treasury was more than just economic. TARP suffered more heavily in the political sphere than it did in its economic influence. The primary issue with the rollout of TARP was that it did not consider political and moral considerations within the rules of its program and was instead only interested in the technocratic fixes that would save shareholder value.

If economics is strictly an amoral science, then it stands to reason that TARP should be viewed more favorably given that it not only prevented another Great

Depression by providing cheap capital to financial institutions that needed it but also produced a profit of $25 billion for taxpayers of the $205 billion allocated through the program. (Blinder, 2013) However, this is not the case because it was considered by the public to be “a giveaway to undeserving bankers, even as millions of homeowners struggled to avoid foreclosure.” (Blinder, 2013, p. 203) On top of this, “millions of Americans [still] believe that the money was given to – not invested in – banks.” (Blinder, 2013, p. 203) Therefore, while it may be tempting to split economics into positive and normative considerations, the failed response embedded in the TARP program shows that such distinctions may be artificial and deny the reality that economic reasoning and moral/political reasoning are intertwined.

While the United States’ response is characteristic of one that did not appreciate the moral and positive aspects of economics, it stands in sharp contrast to that of Iceland’s response. As will be described in the next chapter, Iceland did not bail out its most prominent banks, took high-level executives and political figures to court for their roles in the lead-up to the crisis. As such, the response will be analyzed to see how the U.S. can improve its response to economic issues in the future by taking into account both economic and moral reasoning as methods of analysis that are not separate but interdependent on one another.

Chapter 5: The Fallout and Legal Response to the Financial Crisis in Iceland

After Lehman Brothers declared bankruptcy in the United States, fear set in across the international financial market because of the concerns related to the interconnectedness of the globalized economy. With this, nearly every bank that had an international presence feared that their balance sheets were corrupted with assets just as badly valued as the mortgage-backed assets in the United States. However, for Iceland's three big banks, Glitnir, Landsbanki, and Kaupthing, the underlying problems that were specific to Iceland's banking sector further complicated the issues and resulted in a catastrophic financial meltdown, comparable only to that of Greece.

The market manipulation schemes that were taking place under the nose of stakeholders to prop up the stock prices of the big three banks resulted in illiquidity for Iceland's institutions. Once panic set in and runs on the banks became prevalent, creditors and customers who parked their assets into Icelandic banks realized that their money was nowhere to be found. This was because, unbeknownst to them, the bank's customers had supplied them with the funds that would eventually be loaned out to would-be investors that would take the money to buy more stock in the banks that were lending them the money. Couple this with the fact that many of the banks participated in market transactions that are incredibly volatile, such as currency swaps and credit default swaps. The perfect storm was created to wreck the Icelandic financial sector. (Nguyen, 2017) Thus, after the fall of Lehman Brothers and the loss of trust in the international economy, “high levels of short-term debt, risks, and low liquidity” doomed Iceland’s banks to go bankrupt. (Nguyen, 2017)

While the issues related to liquidity were solved with the TARP program buying up shares in failing domestic financial institutions, that was not an option for Iceland. The government could not take the same approach to save their economy because Iceland did not have a lender of last resort, like the Federal Reserve in the U.S. Along with the fact that “the total size of the Big Three’s assets [were] ten times the size of Iceland’s GDP,” Iceland’s government could simply not come up with enough money to buy their way out of the crisis. (Nguyen, 2017) The banks in Iceland were not just too big to fail, but they were too big to be saved.

Adding to the embarrassment, without the insurance similar to FDIC (Federal Deposit Insurance Corporation) in the United States, investors in countries such as the United Kingdom, Netherlands, and Germany lost virtually all of the money that they had deposited in high yield savings accounts from Icelandic financial institutions. Specifically, the international appeal of Landsbanki’s savings account, Icesave, exposed many investors from these countries to the issues underlying Iceland’s financial system. (Jones, 2008) When Iceland’s currency and the stock market went underwater, and foreign investors rushed to withdraw their funds, they were horrified to find that there was no money to be found.

In response, the United Kingdom’s chancellor of the exchequer (Alistair Darling) reached out to the Icelandic minister of finance (Arni Mathiesen) to understand

Iceland's plans for compensating investors for their lost deposits. (Boyes, 2009) However, the conversation proved unfruitful and left the impression that Iceland was going to reimburse the missing deposits of its own citizens before compensating international investors. (Boyes, 2009) As a result, "the U.K. government froze Landsbanki's assets using the Anti-terrorism, Crime, and Security Act," which was legislation that was originally designed to stop money laundering related to terrorism post-9/11. (Nguyen, 2017) The move from the United Kingdom spoke volumes as it effectively labeled Icelandic financial institutions as terrorist cells and solidified Kaupthing's fate to be nationalized by the Althing, the equivalent of the U.S. Congress in Iceland. Thus, the reputation of Iceland being an international player in global finance was tarnished by its inability to appease foreign stakeholders in the wake of 2008.

As the dust began to settle, many Icelanders began to wonder what had hit them. It was as if everything was fine one day, and then their world fell out from under them the next. With 80% of the stock being wiped out and 97% of the banking sector collapsing over the course of three days, people were rightfully demanding answers. (BBC News, 2016) As a result, a special commission headed by Icelandic special prosecutor Olafur Hauksson was created to investigate the causes of the financial crisis and to determine the level of criminality involved in them, if any.

The Special Commission: 28 Cases and 29 Bankers

After the nationalization of the big three banks, "committees were established to audit and go through the banks' operation." (Nguyen, 2017) As they started to dig through the records, Hauksson has noted that "in the beginning, we thought we may find something that was linked to the bank collapse itself; someone trying to take his chance because of the confusion of the crisis… but what came up was that many of the cases we investigated stretched back several years." (BBC News, 2016) Ultimately, what they found would lead them down a rabbit hole of litigation that would span the course of nearly eight years and 28 court cases.

The results, as Anh Nguyen lists in her study on the Icelandic response to the crisis, are starkly different to those of other countries:

- In 2012, Geir Haarde, former Prime Minister was found guilty for one of the three charges relating to the 2008 crisis. However, he was cleared of the other two and did not face punishment. (Wilson, 2017)
- In February 2015, the Supreme Court handed down a sentence of five and a half years to Hreiðar Már Sigurðsson, former CEO of Kaupthing and a 4-year sentence to Sigurður Einarsson, the chairman of Kaupthing. (Iceland Magazine, 2017)
- In October 2015, Sigurjón Árnason, former CEO of Landsbanki was sentenced for three years. The Supreme Court also sentenced Elín Sigfúsdóttir, former director of corporate lending, to one and a half years. And Steinþór Gunnarsson, former director of brokerage, received a nine-month sentence for market manipulation. (Iceland Magazine, 2017)
- In late 2015, the former CEO of Glitnir Bank and two other bankers were sentenced to prison for up to five years with the charge of market manipulation and breach of fiduciary duty. (Simanowitz, 2016)

- In October 2016, the Supreme Court issued a guilty verdict to nine bankers involved in the Kaupthing Bank market manipulation case. Among the defendants were former CEO of Kaupthing Luxembourg, a former manager, former directors, and a former credit representative. The sentences ranged from one year to more than four years. One of the charges involved the illegal loans to a foreign investor to buy Kaupthing's shares in an attempt to boost market confidence during the pre-crisis months in 2008. (Sims, 2016)
- By February 2016, Iceland had sentenced 29 bankers to prison for their role in the crash. (MintPress News Desk, 2016)

Comparing this to the United States response, where only one top-level finance executive was sentenced to 30 months in jail, the Icelandic response was radically different. (Eisinger, 2014) Instead of seeking criminal convictions, the U.S. Department of Justice decided to settle with financial institutions. The settlements reached between U.S. financial institutions and the Department of Justice are listed as follows:

Name of Financial Institution	Settlement	Value of assets reported in earnings report from the year it was fined	Percentage of settlement compared to total value of assets
Credit Suisse	$5.3 billion	$803.4 billion	0.7%
Goldman Sachs	$5.1 billion	$878 billion	0.6%
Deutsche Bank	$7.2 billion	$1.67 trillion	0.4%

Citigroup	$7 billion	$1.91 trillion	0.4%
Bank of America	$16.6 billion	$2.15 trillion	0.8%
JP Morgan Chase	$13 billion	$2.42 trillion	0.5%

Sources: Reuters, Justice Department, company earnings reports

For an individual, an amount of money equal to 0.8% of their assets would undoubtedly be a significant amount to be fined. For example, going back to the speeding ticket scenario from chapter 2, an individual with a net worth of $121,700 (the median net worth of a U.S. household) has to pay $973.60 if fined an amount equal to 0.8% of their total assets. (DeMatteo, 2021) However, unlike the case of an individual, the legal settlements were between the financial institution and the government. Therefore, to determine if the moral weight of the fines was distributed correctly, the settlements should also be accompanied by a reduction in salaries and bonuses to top executives at firms that settled with the Justice Department.

The opposite occurred and led to sharp criticisms around the handling of executive compensation. As ABC reported on July 30th, 2009, "Bank of America, which also received $45 billion in TARP money, paid $3.3 billion in bonuses, with 172 employees receiving at least $1 million. Merrill Lynch, which Bank of America acquired during the credit crisis, paid out $3.6 billion." (Bernard, 2009) The report also goes on the name Citigroup, JPMorgan Chase, Goldman Sachs, and other financial institutions as those that also gave out billions of dollars in bonuses despite receiving federal assistance to save them. While these organizations were fined for their roles in the financial crisis, do these settlements act as negative incentives to avoid the same risky behavior that caused the financial crisis?

If the settlements are fines, then the effects of those fines should be felt throughout the entire organization. Particularly, the C-Suite executives should have these fines reflected in their performance bonuses because they manage and implement corporate strategy. However, suppose top executives do not feel the ripples of these legal settlements. As stated in the 2nd chapter, fees are a cost of doing business, while fines are reparations for past actions that carry moral weight. In that case, the fines given to those financial institutions in the United States are practically fees because they were ultimately a cost of doing business to financial institutions instead of changing the perverse profit incentives of banks and investment firms. If the profit incentives had changed, it would have been reflected through the performance bonuses of high-level executives.

With this in mind, it is clear to see the differences between the Icelandic and American responses to the financial crisis. Iceland did not bail out its banks and held financial executives to task for their roles in the financial meltdown. In the United States, the banks were bailed out, and executives were left off the hook for the actions of their organizations. Thus, the response from the United States is flawed because of legal settlements being instituted that pose as fines but are pragmatically fees.

Chapter 6: The Positive and Normative Connection

From both the American and Icelandic perspectives, the causes of the financial crisis can be traced back to the separation of ethical considerations from practices in business and economics. For America, neglecting the significance of ethics for mortgage lending, financial advising, and rating securities led to the panic of 2008. In Iceland, the corruption in the deregulation of markets and market manipulation conducted by the big three banks were spurred by separating economic reasoning from its moral implications. When the music stopped, those politicians and economists that trumpeted the beliefs of neoliberalism and laissez-faire governmentality were left in shock as the system plummeted on September 15th, 2008.

While it may seem easy to paint these neoliberals as strictly right-leaning politicians and Chicago School economists, as seen with Michel Foucault, this is an oversimplification. The appeal that neoliberalism has prevails across political ideologies because it touts economic reasoning as a way to distribute resources and make decisions that do not factor in normative attitudes. Conversations over ethics and morals are difficult to have, and market reasoning has been considered an objective way to reach decisions. As specified in the chapter on ethics, the basic appeal of market reasoning is that markets do not judge the preferences they satisfy and do not ask whether some ways of valuing goods are higher or worthier than others. This concept drew Foucault's attention because he was trying to move away from his conception of discipline and toward a system of government that was more focused on limiting itself than regulating the lives of its citizens based on morals or other normative judgments.

However, Foucault's argument for having economic reasoning replace previous governmentalities that took morals and normative judgments into account is fatally flawed because economics and its methodology are not strictly objective. Moreover, while the study of economics has been generally split up into positive and normative aspects, the dividing line between them is not so simple in its practical applications. In fact, one has to consider both a decision's positive and its normative ramifications for it to be effective.

The textbook definition for the field of economics is the study of how communities of people distribute scarce resources. However, the problem lies in the fact that, in examining the causes of the financial crisis, it is easy to get caught up in the complexity of the financial products themselves (the scarce resources). While the speculation of these products did contribute to the financial crisis, they were not the root cause. To quote Shakespeare, "the fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings."

The failing of the United States' TARP program is that it treated only one aspect of the problem and not the human, normative element that was also present. Moreover, Secretary Paulson's missteps, particularly around his written memo and opinion on executive compensation, negatively impacted the public's perception of the government's actions even though it was technically successful in the long run. Also, the U.S. Justice Department's response to settle instead of pursuing legal action against those who knowingly acted recklessly for higher returns was also a mistake.

My message is not that every person who served as a mortgage broker, investment bank analyst, or auditor at a rating agency is at fault for the crisis. There was certainly a combination of people who did not know what was going on, who only understood a small part of the big picture, and who understood the risks inherent to the pre-2008 financial system but chose to ignore it to keep the cash rolling in. To send only one person to jail over the financial crisis in the United States and settle the rest out of court, however, falls below the threshold of holding financial actors accountable.

Instead, Iceland took a different approach that, while not completely solving the country's economic woes, showed that its judicial system had the integrity to stand up for its values and hold unethical bankers accountable. By taking bank executives and high-level politicians to court, Iceland's government demonstrated that no one is above the law and that white-collar crime will be punished just as much as other types. While the technical functions of solving the economic recession have also been addressed, it is the combination of addressing both the normative and positive aspects of the causes of the financial crash that makes the Icelandic response successful.

While it is true that not every person who knowingly contributed to the financial crisis could not have been put on trial, especially with the complexity of the causes, that is not what I am suggesting should have happened. The aspect of the Icelandic approach that should be emulated by the United States is not just to settle out of court with organizations whose actions contributed to the financial crisis but to hold them publicly accountable, to assert that they did something wrong and that they have to pay for their unethical behavior. When the American Justice Department settled out of court with an amount of money that seemed high, it only represented a fraction of the organization's assets, so the unintentional result was that these settlements might have been considered fines instead of fees.

In the observational study with the Israeli daycare centers, labeling something as a fine does not necessarily mean that it will be treated as one. Instead, the fine needs to be large enough to register in the offender's mind that he or she did something wrong and is being punished for it. If those two things are not established, and there is no moral weight to the price being paid, then it will devolve into a fee, which carries no such moral stigma.

The amount paid by financial firms that had an active role in the crisis amount to a fee and not a fine. With the amount of money that they paid as a result of the settlements in comparison to the overall amount of their assets and the lack of a full judicial proceeding, it is hard to imagine this as anything else than Jeff Bezos getting a traffic violation. To be ethical (as the Icelandic response), the outcome would not have to be that everyone who is charged with crimes related to the great recession is sentenced to pay fines or serve jail time. Instead, it is about realizing that without carrying out legal proceedings, citizens of a country such as Iceland or the United States may lose faith in the Judicial system and other institutions within the government.

The comparison between the United States and Iceland also highlights another important aspect of economic decision-making, namely how simply putting a price on a commodity influences our attitude toward it. With the discussion over the viatical industry, the primary ethical issue that came with the investment came with how it shifted attitudes toward death. For the investor to make the most return on their money, it was in the best interest of the investing party to hope that the person on the other side of the deal dies sooner rather than later. While both parties entered into the agreement willingly, the investment lies in a morally gray area that society must either choose to persist or end because of its morally problematic incentives.

By the same token, by fining investment and banking firms for their role in the crisis, we are subtly sending a message as to the attitude that society has toward companies that grow too big to fail. Namely, Wall Street actors that pursue risky and reckless behaviors will be praised when they win and bailed out by Main Street when they lose. While they still may have to pay some fines in the end, the amounts that they have paid previously (the amounts listed in the previous chapter) are tantamount to a speeding ticket for an individual.

Thus, in the legal proceedings against unethical practices in the financial industry, we are not just fining or disciplining those responsible. We are also creating value judgments about how we want our society to function. While a worry of the Justice Department might have been that the stock market would take a further hit if charges were filed against financial firms, that is not an excuse. In fact, it leads to the same issues that we faced with Secretary Paulson's mistaken reasoning for not including executive pay limitations. The American people's faith in the integrity of our government institution depends on its departments upholding their values even when the outcome of doing so is uncertain. It is not so much the consequences of it that are important, but the means by which the government acts that maintain its integrity. Unlike the ideas of the Ordoliberals and Foucault, politics should determine economic action, not the other way around.

As Jonas Antonsson said at the beginning of this thesis:

[There came a realization that] all we interact with is someone's idea. A plane, the monetary system, the banks, the government. These are ideas that become reality through the creation process. You start to understand that you have a much deeper or bigger impact in this whole process than you think you can have because it is much more fun to be a part of the creation process than just be a consumer of it. We've seen where consumerism leads [us]. If you understand the creation process, you can start to live your own dreams instead of [being] stuck in the dreams of others. (Jerrett, 2013)

With the realization that economics and its reasoning are not simply about pure objectivity but also about our personally- and societally-held values, we can now take part in this creation process. The question is, can the United States recognize the normative functions of economic decision-making in the next crisis like Iceland, or will it be doomed to repeat history?

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