In late October, Alan Greenspan testified before Congress that “We are in the midst of a once-in-a-century credit tsunami.” Essentially we have a catastrophic failure of our financial sector to the degree that in mid-September, Connecticut Senator Chris Dodd paraphrased warnings from the Treasury and the Federal Reserve that “we are literally maybe days away from a complete meltdown of our financial system.” This catastrophic failure has triggered a world-wide recession of unknown depth and duration.

 Failures of Prudence

There were early warnings. For example, in February, 2002 Warren Buffet’s annual letter to Berkshire Hathaway shareholders cautioned, “we view [derivatives and the trading activities that go with them] as time bombs, both for the parties that deal in them and for the economic system.”

This catastrophic failure was foreseeable. While investigations will uncover fraud, this failure is not principally the result of criminal wrongdoing. Rather it is clear that many of our private financial sector and public sector leaders failed with respect to the virtue of prudence. Prudence (from the Latin prudentia meaning foresight) is the ability to discern sensible and right action in the circumstances of a given time and place using foresight, reason, and self-control.

The virtue of prudence also calls on private financial sector and public leaders whose judgment is proved after the fact to have been lacking foresight, reason, and self-control to acknowledge mistakes, and learn from, and make amends for the mistakes. Put another way, leadership is about having directing authority or influence over others, but ethical leadership, embodying the virtue of prudence, will exercise the authority or influence using foresight, reason, and self-control including the habit of self-assessment – taking feedback and reflecting on decisions, particularly mistakes, to learn from and make amends for the mistakes. Ethical leadership sees a “once-in-a-century credit tsunami” as a once-in-a-century opportunity to learn how to do better in the future.

Our private financial sector and public leaders include people with either formal directing authority or significant influence (or both) on the financial sector. Members of the legal profession dominate leadership in the public sector constituting 59 percent of all Presidents, 45 percent of the members of Congress in the period 1960-2004 and 100 percent of the judicial branch; they also occupy positions of substantial influence in the private sector including 10 percent of the CEOs of S&P 500 companies and all the general counsel positions.
Our private financial sector and public sector leaders, including many members of the legal profession, have made catastrophic mistakes of foresight, reason, and self-control imposing worldwide pain on others, but virtually none of them is publicly undertaking any self-assessment about their responsibility. Virtually all leaders are claiming it is someone else’s fault. They are compounding their failures of prudence.

**Societal Response to the Catastrophe**

Our societal response to date is focused on ameliorating the widespread failure of trust in the financial sector through a bailout of the sector in the hope this will restore the functioning of the credit markets and mitigate the recession. The second step will be regulatory reform of the financial sector to use government to cabin the worst private sector excesses contributing to this disaster.

A third critical step the public expects is self-assessment to learn from and make amends for mistakes. Public sector leaders must undertake a self-assessment of their own failures of prudence. Regardless of the government’s regulatory response, private financial sector leaders, including leaders in business and the gate keeping professions of law and accounting, should also undertake self-assessment.

In my view, many of the failures of prudence in both sectors are not amenable to government regulation but are the results of a cultural failure of excessive emphasis on short-term self-interest at the expense of “self-interest considered upon the whole.” Thomas Reid, who, in 1766, followed Adam Smith as the chair of moral philosophy at the University of Glasgow, used “self-interest considered upon the whole” to emphasize the ethical foundations underpinning the market that lead to trust in an enterprise and the market itself. When trust is lost, a market’s or an enterprise’s ability to transact business is substantially damaged. Excessive short-term self interest undermines foresight, reason, and self-control, as well as habits of self-assessment, and leads to a loss of trust.

I believe our cultural institutions are substantially failing at the project of socializing our leaders in business, the professions, and government into an ethical professional identity, including “self-interest considered upon the whole” and the virtue of prudence. Education, including graduate education, should undertake its own self-assessment of the socialization of our public and private sector leaders to learn from this once-in-a-century catastrophe.

**Specific Examples of the Failures of Prudence**

Like many others, I am trying to understand the various failures of prudence that coalesced to produce this catastrophe. What follows is an outline of my understanding of the major failures of prudence.

1. **Public Sector Leadership’s Failure**
A. Affirmative Creation of Moral Hazard (insulation from risk that causes parties to behave differently than they would have if fully exposed to the risk)
   1. The Federal Reserve’s loose monetary policy that kept interest rates low and encouraged leverage.
   2. The Community Reinvestment Act and aggressive government policies to encourage subprime mortgages.
   3. Policies toward Freddie Mac and Fannie Mae that allowed profit to accrue to private sector but risk to be underwritten by government.
   4. Financial institutions that are “too big to fail” and government’s role in creating them.

B. Bank regulatory agencies failure to act when excessive leverage and risk in subprime markets and derivatives were already becoming clear.

C. Failure to Regulate – Commodities Futures Trading Commission’s Failure to Regulate Derivatives

D. Lobbying of Government by the Financial Sector and Consumer Groups to Encourage the Government’s Role Toward Affirmative Creation of Moral Hazard

II. Private Financial Sector Leadership’s Failures of Prudence

A. The Board’s and Senior Management’s Duty to the Shareholders to Create and Protect Value (even if public sector leaders create substantial moral hazard). A significant proportion of the financial sector’s boards and senior management failed in their duty to protect shareholder value, including, of course, the survival of the enterprise, but also with respect to:

1. risk assessment of the erosion of market discipline of those in securitization process, including originators, underwriters, and credit rating agencies;
2. risk assessment of the creation of financial instruments with guarantees where risk and valuation were not clear;
3. risk assessment including reputational risk affecting the trust necessary for the enterprise to secure loans and financing;
4. risk assessment including the problem of correlated risks, systemic risk, and contagion (taking into account also the thin markets in which many of these assets were traded);
5. recognition of moral hazard of short-term rewards to those creating and selling long-term risks for both the enterprise and the system in which the enterprise operates (e.g. subprime mortgage brokers get paid for monthly volume, and managers involved in securitization get paid immediate commissions that do not recognize long-term risk);
6. creation of senior management compensation systems tied to both creation and protection of value that do not encourage excessive risk-taking and that do not, by virtue of total executive compensation packages that shock
the society’s sense of fairness, undermine the public’s trust in the financial sector; and
7. recognition of the moral hazard when the investment banking partnerships became publicly traded corporations.

B. The Board’s and Senior Management’s Duty to Other Stakeholders (including the duty to foster reputational capital supporting society’s trust in the financial markets and private ownership and management discretion in those markets). The fulfillment of these duties also contributes to the creation and protection of shareholder value. A significant proportion of the financial sector’s boards and senior management failed adequately to perform this duty.

C. The Private Sector Gate Keepers’ Failures of Prudence

Private sector gate keepers in the market are the people trusted to protect the public from unlawful conduct and catastrophic failures of prudence by boards and executive management. In order to generate public trust, the gate keepers pledge their professional reputational capital that the board and management are meeting their duties. The public charges gate keepers in particular to exercise prudence – foresight, reason, and self-control – in the exercise of the gatekeeper’s independent professional judgment.

Rating agencies such as Moody’s bond-rating service evaluate credit worthiness. They opened the door to Wall Street for the mortgage industry by providing gold seals on the securitization of mortgages (and other instruments such as credit card debt and auto loans). Rating agencies collect their fees from the organizations whose bonds they are rating. Substantial failures of prudence in the current catastrophe are obvious.

In the social contract of the peer-review professions such as accounting/auditing and law, the public grants exceptional rights of occupational control over the work different from the usual employer/employee relationship of the market in order to protect the independent professional judgment of accountant/auditors and lawyers. The accountants/auditors verify the accuracy of financial statements. The evidence is not clear if and how much the accountants and auditors were exercising professional skepticism and independent judgment when evaluating financial statement assertions in the current catastrophe. The scope of the catastrophe suggests failures of prudence. Congress, acting on behalf of the public, substantially renegotiated the social contract of the auditing and accounting profession to reduce its autonomy after finding the profession should have done much better to protect the public in the Enron and other scandals of the early part of this century.

Lawyers for the financial sector enterprises are to hold in tension roles as representative of the client, officer of the legal system, and public citizen having special responsibility for the quality of justice. The Rules of Professional Conduct mandate lawyers “shall exercise independent professional judgment and render
candid advice.” The comment to the Rule provides, “… a lawyer’s advice at its best often consists of recommending a course of action in the face of conflicting recommendation of experts.”

The evidence is not clear if and to what degree the financial sector’s lawyers were performing their role as a counselor exercising prudent and independent professional judgment. The scope of the current catastrophe suggests many lawyers were acting as overly zealous transactional engineers not prudent counselors giving the boards and senior management independent professional judgment on both their duties to protect shareholder value and to assess risk prudently.

Of all the private sector gatekeepers, the lawyers have the most protection for the exercise of independent professional judgment because of the strength of the legal profession’s social contract. The public can justifiably expect members of the profession to exercise their independent professional judgment to protect the public. It is not acceptable for lawyers tasked with asking the hard questions to help boards and senior management to think prudently through risks to claim now that the risks leading to this catastrophe were too multidimensional, complex and opaque for the lawyers to understand. To protect its social contract, the legal profession should undertake a self-assessment of the degree to which members of the profession properly fulfilled their gatekeeper duties in this catastrophe.

III. Graduate Education’s Role to Foster Ethical Professional Identity including the Virtue of Prudence

The new executive branch administration and Congress will enact government regulation to increase financial sector stability in the mortgage and derivatives markets. This should follow a self-assessment of public sector leadership failures causing the catastrophe, but, in all likelihood, there will not be such a self-assessment.

Regulatory reform alone will not restore the public trust in the financial sector and the market generally. The catastrophe is principally the result of excessive short-term self-interest that undermined prudence and “self-interest considered upon the whole.” This is a failure of our cultural institutions to socialize our public and private sector leaders into an ethical professional identity that informs their leadership.

Restoration of the public’s trust in the prudence and internalized ethics of our public and private sector leaders requires self-assessment to learn from and make amends for mistakes. Virtually no public and private sector leaders are doing this self-assessment. Graduate education in business and law is one of the principal cultural institutions shaping the ethical professional identity of our private sector leadership. Legal education also plays an enormous role also in shaping the ethical professional identity of a large share of our public sector leaders. Graduate education in both business and law should undertake a self-assessment about the degree to which it is successfully helping students to internalize an ethical professional identity.
One window on the degree to which graduate education is fostering an ethical professional identity is the high level of cheating among graduate students. A survey conducted from 2002 to 2004 by McCabe, Butterfield, and Trevino of more than 5,000 graduate students found that 56 percent of graduate business students and 45 percent of law students admitted to one or more incidents of cheating in the last year. Our institutions of culture, including graduate education, can do much more to foster each student’s ethical professional identity including the virtue of prudence as a check on excessive short-term self-interest.