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WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE

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I. Background

On September 15th, 2008, Lehman Brothers – at the time, the world's fourth largest investment bank – filed for bankruptcy. This event marked the beginning of a downturn of the public's trust level in the U.S. financial system – a downturn clearly visible in the price of the Dow Jones Industrial Average as it steadily declined by three thousand points in the following four weeks. Outwardly, the financial crisis of the late 2000s may appear to have had a sudden onset, but a closer look reveals that the crisis was the result of a years-long buildup of multiple factors. A process of steady deregulation in the financial sector over a period of decades resulted in lumbering, monopolistic, "too-big-to-fail" banking institutions with increasingly unhealthy balance sheets and growing freedom to make investments with consumer deposits. Before the crisis, financial technologies added new complexity to investment vehicles including CLOs and derivative markets. The inherently complicated nature of ~~such securities~~ makes them difficult to price and rate without thorough consideration and understanding which, at the time of the crisis, many market participants – from finance executives to retail investors – ultimately lacked. Despite pressure from several prominent figures, the regulatory arms of the US government failed to monitor the situation and intervene when necessary. The rise in popularity of complex derivatives helped facilitate another key contributor to the crisis: reckless subprime mortgage lending. Commercial banks and other lending institutions were able to make loans to unqualified borrowers with unreasonable conditions and then sell them off their balance sheets – either individually as assets that fetched high prices due to their large interest payments, or packaged together as complex structured vehicles. Rating agencies – the opinions of whom were relied on throughout the investment community as accurate reflections of the financial health of a myriad of entities –gave unwarranted high ratings to investment banks. . These inflated ratings increased

the demand for subprime structured finance vehicles and promoted their cancerous infiltration of the financial system. To make matters far worse, once certain investment bankers began to understand the subprime mortgage market and the potential for its eventual implosion, they methodically promoted mortgage backed securities to their clients and took short positions on the mortgage market to benefit from its downfall. Clearly, contributing deficiencies are multifaceted, but a common theme is that every party involved failed to act as so many stakeholders in the financial system trusted and relied on them to act. Once the irresponsible and thoughtless behavior of all parties culminated into a collapse of the US financial system, countless people around the world found their situations impaired by a crisis– the nuances of which were difficult for the majority to understand.

In November of 2008, the United States Senate Permanent Subcommittee on Investigations, headed by Chairman Senator Carl Levin of Michigan and Ranking Minority Member Tom Coburn of Oklahoma, launched an initiative to objectively research, with painstaking detail, the causes of the recent financial crisis. The end result was released to the public on April 13th, 2011. The 640-page report is titled "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse" (hereafter the "Coburn-Levin Report" or "the Report") and is based on numerous depositions, emails, official documents and expert consultations. The Report categorizes the various failures and indiscretions that contributed to the crisis into four parts and uses case studies to examine each factor. The first is High Risk Lending, illustrated by the case study of Washington Mutual Bank's reckless lending and eventual collapse and buy-out by JP Morgan Chase. The second is Regulatory Failure, illustrated by the case study of the Office of Thrift Supervision and its failure to perform its basic regulatory functions. Thirdly is Inflated Credit Ratings, illustrated by the case study of rating agencies Moody's and Standard and Poor's

(S&P) and their flagrantly incorrect distribution of high ratings to investments that were truly junk-grade. Lastly is Investment Bank Abuses, illustrated by the case studies of Goldman Sachs and Deutsche Bank and their failures to disclose short positions in investments they were promoting to their clients, the motives for which range from ignorance to selfish non-concern, bordering on malice. The Report also makes detailed recommendations for each category to improve operations and prevent similar failures going forward. The following paper will explore the entwined events and trust violations demonstrated by each case study, examine the internal shortcomings of each party and the underlying causes of the trust violations, and finally discuss the Report's recommendations and their potential effectiveness in trust restoration. Considering the variety of deficiencies which facilitated the trust violations of the crisis – faulty organizational structures with completely misaligned interests, cultures that hindered performance, misguided employees with low levels of competence in key functions and leaders with a total lack of benevolent concern for various stakeholders – recommended solutions have a formidable task as they aim to maintain functionality and restore trust. The financial industry is arguably disinclined to be a "high-trust" environment, but interventions from outside government-based regulatory agencies may by the best way to restore optimal trust in the system and recover from the overwhelming failures of the crisis – provided the agencies be decisive and consistent in the enforcement of new standards.

II. Trust Violations: What Happened?

1. High Risk Lending: Washington Mutual

Washington Mutual (WaMu) was a bank that originated in the western United States in the late 1800s and established itself through the years as community-oriented and mortgage-focused. By the 1990s, WaMu had expanded to be the largest community thrift bank – and the sixth

largest of all banks – in the country. As the decade ended, the bank sought to feed its growth and take advantage of new profit opportunities in the evolving financial environment – mainly, subprime lending (subprime loans inherently paid large coupons and therefore fetched high prices when syndicated). It acquired Long Beach Mortgage Corporation which would become the bank's subprime lending arm. The synergy of this acquisition allowed WaMu to exponentially increase its risky loans and shift to an aggressive portfolio extremely out of character for a community thrift bank: conservative, fixed-rate mortgages comprised 64% of the bank's origination portfolio in 2003, but only 25% in 2006. In the same timeframe, risky loans jumped from 19% to 55% of the same portfolio (Coburn-Levin, 48). WaMu even developed its own high-risk asset type – the Option Adjustable Rate Mortgage (Option ARM) – which initially only requires a relatively low interest payment, but on which minimum payments can increase exponentially due to risk factors such as rising long-term interest rates and negative amortization on the loan's principal balance. WaMu employees could underwrite Option ARMs to borrowers based on the more favorable initial terms of the loan, and in this way could reach a larger pool of subprime borrowers. In this way, Option ARMs are one example of a financial product that was clearly tailored to the purpose of predatory lending. Furthermore, they were issued mainly through WaMu's "Retail" mortgage lending channel and were considered prime loans. WaMu also considered mortgages bought via its "Wholesale" channel to be prime – but these mortgages were acquired from third-party lenders with which bank employees had infrequent interactions and to which they provided little or no training. A significant portion of the bank's subprime mortgages were also acquired from third-party lenders in a similar manner (Coburn-Levin, 54).

Washington Mutual clearly embarked on a path of diversion from its original mission as a reliable community lender with an influx of risky lending, "creative" asset structures and

disputable management procedures. Contributing to the violation of trust is the way this diversion was strategically planned and how its consequences were anticipated potentials rather than random, unforeseen side effects. WaMu developed an official High Risk Lending strategy and presented it to its Board and regulators in 2005, complete with a definition of what exactly qualified as high-risk lending. A high-risk loan, according to this definition, was a mortgage on a single-family residence with a loan-to-property value ratio equal to or above 90%. Notably, industry standard previously deemed any LTV ratio above 80% to be subprime (Coburn-Levin, 63); WaMu was willfully blazing a trail in the practice of risky lending. Furthermore, top executives were aware of a strong possibility of a mortgage crisis, as emails between CEO Kerry Killinger and Chief Risk Officer Jim Vanasek from March of 2005 indicate clear acknowledgement of the risk of a "probably not great" outcome, even as the bank's subprime lending was on an unrelenting upswing. Says the Report, "Despite Mr. Killinger's awareness that housing prices were unsustainable, could drop suddenly, and could make it difficult for borrowers to refinance or sell their homes, Mr. Killinger continued to push forward with WaMu's High Risk Lending Strategy" (68). Much of this apparent lack of concern likely came from the understanding that the bank's ultimate intention was to securitize and distribute the vast majority of the subprime loans it originated; it planned to profit substantially from these sales and the default and price risks would be unloaded from its balance sheets. From 2000 through 2007, the bank packaged and sold hundreds of billions of dollars' worth of risky loans – at least $77bn of subprime loans and at least $115bn of Option ARMs. Despite having injected a massive amount of such securities into the market, it was impossible for the bank to continue to sell off every bad asset out of its portfolio. Defaults became rampant and losses sustained were considerable. This increasingly uncertain environment coupled with the panic-inducing Lehman

Brothers collapse prompted an eight-day long, $16.7bn run on the bank in September of 2008, which subsequently incited the Office of Thrift Supervision and the FDIC to arrange a buyout of WaMu by JP Morgan for a meager $1.9bn. Equity holders saw PPS drop to about $0.19 from a peak of $45 just a year and a half prior. Several thousand employees were laid off in the months prior to the buyout, and investors everywhere were impacted by the bank's risky lending and mass-securitization practices. Washington Mutual's downfall is considered the largest bank failure in American history.

2. Regulatory Failure: The Office of Thrift Supervision

The Office of Thrift Supervision (OTS) was a regulatory agency that existed to monitor the health and performance of thrift institutions – typically, banks focused on individual and community service and the facilitation of home ownership through responsible, qualified mortgage lending. Most notably, it was the agency responsible for the aforementioned Washington Mutual fiasco. The Coburn-Levin Report attributes WaMu's collapse largely to the OTS's gross shortcomings as a regulator, calling the collapse itself a "spectacular failure" of federal bank regulation (161). In this way, WaMu's indiscretions are the OTS's embarrassments. The bank's business practices were clearly riddled with faults, but the OTS failed to enforce any mandates to restore WaMu's well-being – even after identifying about 500 issues with lending practices, risk management practices and appraisal processes throughout regularly-conducted examinations between 2003 and 2008 (157), the most significant of which were brought to the attention of the WaMu Board of Directors. The agency was inefficient and indecisive – seemingly relying on WaMu to take the lead in internal investigations before conducting its own. The Report continually refers to the OTS's dependence on and deference to WaMu leadership as "unusual" (5). For instance, the Attorney General filed a complaint against WaMu in November

of 2007, accusing the bank of purposely inflating home values when appraising. The OTS did not begin looking into the complaint until after WaMu launched its own investigation – even though it had been aware of the complaint for six months before it was issued (189). When confronted with the bank's dramatic shift from community-oriented mortgage lending to an aggressive high-risk lending initiative, the OTS recommended a presentation of the strategy details to the Board of Directors. The OTS noted that risk management aspect of the bank's five-year plan was lacking in light of the additional risk it was assuming, but took no action. In early 2008, the agency downgraded the bank's CAMEL rating (a private rating of financial institutions by regulators designed to help maintain financial health without causing a public panic) but did not follow through with any enforcement to improve processes.

WaMu's situation continued to deteriorate throughout the year. During this time, the FDIC (the bank's secondary regulatory agency) intervened more and more frequently – obviously concerned about the health of bank's balance sheet and the strain a collapse could place on deposit insurance funds. Tensions rose as both agencies worked towards what should have been a common goal. In July, the OTS requested a Memorandum of Understanding (MOU) from Washington Mutual executives on the state of the bank in the deteriorating climate. The FDIC strongly recommended tangible, enforceable actions for the OTS to take based on the findings of the MOU – adjusting capital requirements, raising the deposit reserve ratio, and increasing reporting requirements. Instead, the OTS agreed to the bank's less decisive plan of action, which involved engaging an outside consultant to review the firm's leadership, risk management and board oversight. Later, the MOU was amended so that a consultant did not have to review board oversight. In a July 31 meeting between the two agencies and WaMu's Board, FDIC chairman Sheila Bair suggested the best course of action might be to find a partnering investor or buyer for

the bank. OTS leaders responded poorly to this suggestion, as evidenced by a strongly-worded email correspondence from OTS director John Reich to Ms. Bair several days later: "I do not under any circumstances want to discuss this on Friday's conference call…. I should not have to remind you the FDIC has no role until the Primary Federal Regulator (i.e. the OTS) rules on the solvency" (201). The tone of the email is stubborn and chastising, and certainly not conducive to any type of collaboration towards maintaining the health of the entity in question. On August 1, the FDIC officially informed the OTS that it believed WaMu deserved a CAMEL rating one grade lower than even the one to which it had been recently downgraded – not an unwarranted assertion for a bank less than two months away from collapse. However, the OTS "strongly disagreed" and continued a policy of benign acquiescence to the bank's insistence on vague, irresolute plans for improvement without any enforcement. It was only when the Lehman Brothers collapse triggered a $16.7bn run on Washington Mutual's deposit holdings that the OTS turned over the bank to FDIC receivership and the two agencies worked together to structure a buyout by JP Morgan Chase. Some WaMu equity holders, who lost tremendous value in the buyout, thought the transaction was poorly-thought out and possibly unnecessary, but its result was certainly preferable to a bailout which could have exhausted the FDIC's resources. Had the OTS not been so resistant to cooperate with the FDIC, a solution to WaMu's collapse may have been researched to the greater benefit of all stakeholders involved. Had it not been so passive in its regulatory duties, the collapse may never have occurred.

3. Inflated Credit Ratings: Moody's and Standard & Poor's

The case studies of Washington Mutual and its primary regulator, the Office of Thrift Supervision, demonstrate how the infiltration of defective securities backed by shoddy subprime mortgages was instrumental in the financial crisis. As previously mentioned, WaMu's central

business objective became to originate, securitize and sell as many subprime loans as possible because investors were willing to buy them at a premium. If the collateral which secured these instruments was so unreliable, why would the market price them so highly? Due to the complex structures of these securitized assets, truly accurate valuation required an often-unrealistic level of due-diligence. Many investors relied on the nation's two largest credit rating agencies (CRAs) – Moody's and Standard & Poor's – to publish reports and issue ratings based on thorough research and complex statistical analysis. CRAs used information from security originators (usually investment banks) to input data into quantitative models and derive default probabilities. Towards the onset of the crisis, Moody's (but not yet S&P) also began incorporating a qualitative aspect into its ratings analyses. This new form of analysis allowed CRAs to consider the past performance of an originator's previous entities and increase loss levels up to 20% for those originators with a poor track record. It was a comprehensive development that ultimately arrived on the scene too late.

Like their responsibilities to the financial community, the failures of these rating agencies were straightforward. Due to legal requirements which mandate that certain institutions such as pension and insurance funds must hold a certain percentage of their portfolios in investment grade assets (those rated above BBB-), rating agencies were under regular pressure to provide inflated ratings. Focusing on report volume and prioritizing market share over accuracy, Moody's and S&P ultimately distributed extremely high ratings to a record number of extremely undeserving assets. In 2002, Moody's rated 540 MBS and 45 CDOs. This numbers rose to 1,200 and 360 respectively by 2006. Moody's RMBS ratings revenue more than tripled in that time (256). A considerable portion of these investments were given AAA ratings (the same rating as debt sold by the United States government), but by 2010, over 90% of these once-AAA-rated

securities were considered junk (267). In addition to distributing ratings opinions which seem carelessly inaccurate in hindsight, Moody's and S&P also contributed to the severity of the financial crisis in July of 2007 when they suddenly engaged in massive downgrades. Although the mortgage market had been on a notable downturn from at least the end of 2006, CRAs waited until the second week of July (questionably in order to push a final influx of rating opinions through) to downgrade upwards of $12bn worth of MBS. The markets were shocked and the subsequent sell-off froze liquidity and forced institutions all over the world to hold mortgaged-backed assets on their balance sheets as values plummeted. Had CRAs acted less rashly, this liquidity freeze may have been avoided. Most importantly, had CRAs issued accurate ratings opinions on risky assets, demand for these securities would have diminished and their infiltration of the market would have been less extensive.

4. Investment Banking Abuses: Deutsche Bank and Goldman Sachs

Investment banks played an extremely integral role in the financial crisis, particularly with relation to the substandard securities which permeated the market. Banks profited from these complex securities on several fronts: by earning millions of dollars in fees to structure and place them with investors, and also by taking trade positions in the secondary structured finance market to earn money for both clients and themselves (proprietary trading). Once the mortgage market started to fail and these securities faced the threat of extreme value decline, some bank employees realized the potential for crippling losses on their long positions in a variety of mortgage-backed securities. They took offsetting short positions (in the case of Goldman Sachs, *net* short positions) but failed to disclose these critical opinions to clients – even as they continued to underwrite and distribute the very types of securities they were shorting.

Gregg Lippmann was a top CDO trader at Deutsche Bank who apparently had a grasp of the mortgage market superior to that of Deutsche's upper management. Throughout 2006 and 2007, he adamantly professed his opinion on structured finance securities: that underlying collateral was sure to soon be worth very little. He advised many of his clients to take short positions in the CDO and MBS market by purchasing credit default swaps (CDS) – insurance against defaults on underlying securities. He asserts in the Report that his advice to go short resulted in significant gains for his clients and about $200 million in revenue for his desk in 2006 (344). While Deutsche Bank managers did not heed Lippmann's advice, they did allow him to take a proprietary short position in the residential mortgage market that resulted in gains of about $1.5bn. Losses from long positions were much greater, however, and the bank's net loss at the end of the crisis amounted to about $4.5bn (320). While Mr. Lippmann was making his opinion known to his fellow employees and to some of his clients, Deutsche was structuring a hybrid CDO called Gemstone VII. Many of the CDO's deals were originated by subprime lenders with poor records – including Long Beach, Washington Mutual's subprime lending arm. Lippmann's trading desk was involved in the asset selection process. Although he believed the assets picked for the CDO were bound to fail (and referred to them repeatedly over email as "crap" [339]), he didn't object to Deutsche aggressively marketing Gemstone VII to a variety of clients. The CDO had a total portfolio capitalization of $1.1bn. Its underlying securities were "virtually worthless" by the time the Coburn-Levin Report was published.

Deutsche senior management insisted on disregarding Lippmann's outlook and taking a large net long position in the mortgage-backed security market. This behavior resulted in heavy losses for the firm and ultimately indicates something closer to ignorance than to deception – especially relative to the behavior of Goldman Sachs during the crisis. In the years of one of the most

catastrophic mortgage crises in American history, the GS Mortgage Department saw net *revenues* of $1.1bn (376). Like every other investment bank, Goldman profited on the upswing of complex structured finance vehicles by collecting hefty fees for underwriting assets, helping subprime mortgage lenders obtain investment-grade ratings, and placing structured securities with investors. It was towards the end of 2006 when the mortgage market began to downturn that Goldman began to shift its position from net long ($6bn in December of 2006) to net short ($10bn in February 2007) (386). It bought massive amounts of CDSs – positions far greater than its ownership of mortgage-backed assets – as a way to generate significant gains on the downturn of the mortgage market. Meanwhile, it was aggressively promoting CDOs collateralized by the securities they were shorting and not disclosing short positions to clients. The Report focuses on four CDOs including Hudson Mezz 2006-1and Abacus 2007-AC 1. Hudson was a vehicle that was attributed entirely to Goldman. The bank had a hand in every aspect of structure and marketing, and was completely in control of underlying asset selection. It had a $6 million equity stake in the vehicle – but that was minimal compared to its short position of $2bn – the entire portfolio capitalization of the CDO (391). In the case of the Abacus, Goldman collaborated with hedge fund Paulson & Co and served only as underwriter and issuer agent. Goldman collected large fees for its role, and in return, permitted and assisted Paulson & Co in selecting a set of underlying assets which were very likely to fail for the purpose of Paulson taking a massive short position. Of course, when GS promoted the CDO to its clients, it did not disclose this information. When the securities (worthless at the time of the Report) declined in value, long investors lost about $1bn while Paulson & Co earned the same amount in gains. Additionally, Goldman had taken naked short positions against the CDO and RMBS market, as well as the ABX Index (a basket of subprime mortgage-securitized bonds) by taking short positions on CDS

contracts "'at every opportunity', according to one trader" (410). Not only was Goldman putting its own interests before those of its clients in the acquisition of these CDS contracts (which will be discussed later), but the massive balance of contracts Goldman did acquire was a driving force in the collapse of insurance provider AIG once underlying securities defaulted. American taxpayers covered most of the $180bn government bailout that the insurance company required to meet its obligations to entities like Goldman, so it can be said that the investment bank's greed allowed it to profit from the mortgage market collapse while the stakeholder group of American citizens suffered. Of course, another stakeholder group that suffered is Goldman's clients who bought into the investment bank's mortgage-backed offerings. It is almost certain that these clients would not have done so had they knowledge of Goldman's enormous short positions against the same instruments the bank was promoting.

III. Underlying Causes: What Facilitated the Trust Violations?

It is apparent in all four case studies that inherent flaws existed in the organizations which allowed some rather remarkable trust violations to take place. To examine where the organizations in question went wrong, we can look at how they failed to maintain characteristics of organizational trustworthiness as per Dr. Robert Hurley's book, The Decision to Trust. Also described in the book are critical elements of general trustworthiness which are incorporated into the Decision to Trust Model (DTM) and impact the level of trust associated with any situation. Examining organizational shortcomings from these perspectives can help us see where Washington Mutual, the Office of Thrift Supervision, Moody's and S&P, and Deutsche and Goldman Sachs went wrong.

1. Leadership and Employee Selection & Management

Although its subprime lending initiatives ultimately resulted in an organizational failure, Washington Mutual's operations were quite sophisticated. The types of loans it originated, for instance, were far from vanilla (complexly structured negative amortization loans, Option ARMs), and they were packaging these loans to sell off their balance sheets by securitizing them into vehicles that even veterans of the financial world didn't fully understand. With such high levels of complexity and billions of dollars on the table, one would expect all employees to be highly experienced and qualified and that a strong vein of leadership would extend through all functions of the organization. Of course, given that WaMu was established as a reliable community resource, one would hope that the firm's leaders would guide employees responsibly, even as the firm embarked on a less conservative lending initiative.

In the decade leading up to the mortgage crisis, Washington Mutual acquired smaller lending companies such as Long Beach, American Savings Bank and PNC Mortgage – more than 20 such firms in total (Coburn-Levin, 87). While integrating the systems of so many different acquired entities was certain to be difficult, WaMu's management did not take necessary steps to ensure that newly acquired employees were willing and able to uphold the bank's lending standards. The Report states, "From 2004 to 2008, WaMu's regulators repeatedly criticized WaMu's failure to exercise sufficient oversight of its loan personnel to reduce excessive loan error and exception rates that allowed the issuance of loans in violation of WaMu's credit standards" (87). While it's true that the structure of WaMu post-acquisitions would be a synergistic challenge for any company, it was clear that the bank fell short in delegating resources to manage the new employees and third-party brokers whose decisions would be responsible for the bank's portfolio (not to mention responsible for the health of the securities they were pumping into the marketplace). For instance, findings of an OTS investigation

indicated that “each WaMu employee oversaw more than 2,400 brokers” (89). At such a ratio, it was not realistic for original WaMu employees to train newcomers and manage the brokers who were sourcing loans. Integrity is an element of trustworthiness in the Decision to Trust Model, but apparently maintaining integrity and consistency of its portfolio offering was not such a priority for WaMu that it would allocate sufficient resources towards adequate broker supervision and employee management.

Furthermore, the Report indicates that WaMu management was aware of the discretions in the bank’s lending practices in the years leading up to the peak of the crisis. In 2005, an internal Washington Mutual investigation uncovered fraud in the Downey and Montebello loan offices – both of which were considered top producers, and both of which were managed by individuals who had won multiple awards for their high volumes of lending. The Report notes, “A November 2005 memorandum summarizing the [WaMu Risk Mitigation Team] review stated that it found an ‘extensive level of fraud’ caused primarily by employees ‘circumventing’ bank policies” (96). Furthermore, the review found the fraud to be “preventable with improved processes and controls”. Results of the review were passed throughout Washington Mutual, including to the bank’s Chief Risk Officer JimVanasek. Though he agreed in an April 2010 Senate Subcommittee deposition that the results of the internal investigation were “eye popping” (98), no actions were taken to penalize the leaders who permitted such discretions, no training program was implemented, and no policies were amended. With objectively sub-par managers being commended for high-volume lending, even though the loans were based on fraud, it is apparent that the trust element of interest alignment was missing from the equation; what was “good” for these loan office managers would ultimately detriment most of the company’s stakeholders. The trust element of benevolent concern – really, any concern for any interest other

than lending at high volumes and selling off these loans for a profit – was also clearly lacking. Top managers received notice that poor management of peripheral managers was resulting in an insidious proliferation of faulty loans. They responded again as poor managers: with short sight and total inaction. Thus, this was a two-fold leadership failure.

2. Systems - Compensation

Poorly-devised compensation systems played an unfortunate role in the financial crisis for the subjects of more than one of the Report's case studies. In the case of Washington Mutual, compensation was awarded based on loan origination volume. For instance, there existed a "President's Club" – an exclusive club for only those loan officers on the upper echelon of production levels –membership to which included incredible compensatory benefits like exotic vacations and luxurious gifts (144). In a section entitled "Paying for Speed and Volume", the Report describes how subprime lender incentives were tied solely to the amount of loans generated, making "no reference to loan quality" (149). The subpar lending practices of WaMu and its peripheral branches have already been discussed. The combination of senior leaders refusing to step up and penalize employees for their blatant disregard of industry lending standards, coupled with a compensation structure that focused on quantity and ignored quality, essentially ensured the permeation of WaMu's portfolio and structured securitizations with shoddy deals. Had WaMu leaders more concern for company stakeholders and a better comprehension of the impact of speedily generating failure-bound issuances for distribution into the market, compensation structures might have been altered to encourage smarter decision making.

The trust violations of the credit rating agencies can also be partially attributed to a compensation system that was counterproductive to preserving the value for all stakeholders.

Moody's and S&P experienced record-setting revenues during the years of the mortgage crisis onset, doubling from $3bn in 2002 to $6bn by 2007. During this time, compensation for these CRAs was based on a model known as the "issuer pays" model. Here, the firm which requests a rating for its security also pays the agency. This is in contrast to the previous method – the "subscriber pays" model – in which the investor pays for a rating on which he is basing a potential investment. The new model clearly invites a misalignment of interests – described by the report as "a system that creates strong incentives for rating agencies to attract business, and for the issuers and arrangers of the securities to engage in 'ratings shopping' to obtain the highest ratings for their financial products" (273). All for-profit companies strive for revenue and market share. However, the compensation structure of the CRA set them up to be pressured into inaccuracy by powerful security issuers. Moody's and S&P found themselves with an ultimatum between gaining market share and preserving stakeholder interests. They chose to do the former and investors who relied on ratings reports for accurate reflection of portfolio status were jolted when downgrades occurred.

3. Product and Service Delivery

Also in the cases of Washington Mutual and the CRAs Moody's and S&P, a particular key shortcoming in the context of organizational trustworthiness was in the Product and Service Delivery arena. Washington Mutual was securitizing and syndicating an incredibly large volume of loans it had originated. The overarching issue was that these loans were not only super-risky and inaccurately rated, but WaMu was spitting in the face of industry standard with its lending practices. The Report investigates how from 2004-2008, WaMu utilized blatantly shoddy business practices in its subprime lending initiative. For instance, the bank essentially stopped verifying borrower income. According to FDIC records, by 2007, 50% of subprime loans and

73% of Option ARMs were "stated income" loans with no proof required – a lending tool that had been designed to facilitate loans to entrepreneurs and self-employed individuals who did not receive regular paychecks, the "stated loan" option was clearly being overused. Additionally, policy explicitly permitted lending at loan-to-value ratios which were unprecedented in the industry. According to the Report, "federal banking regulators noted that banks should generally avoid issuing loans with LTV ratios over 80%" (92). Apparently unconcerned with such guidelines, WaMu approved lending parameters which would automatically approve up to $1 million in funding for Option ARM deals with LTV ratios of up to 90%. In a further act of what the Report refers to as "risk layering", WaMu factored in an allowable credit score of as low as 620 into this approval model. A community bank undertaking a subprime lending initiative peppered with predatory lending tendencies is hazardous enough without also incorporating such degree of untested, unprecedented risks. An undergraduate student of finance would assert that good risk is mitigated and understood. In buying and selling securities acquired via such perilous methods, WaMu employees were pumping the market full of assets that were far below standard for an established, reputable organization; all without concern for stakeholder interest, all in the pursuit of profit. Shareholders ultimately suffered.

Credit rating agencies were also guilty of profiting from faulty products in a similar way. Yes, CRAs thoughtlessly inflated ratings as a result of issuer pressure and thirst for revenue, but reports may not have accurate even if Moody's and S&P employees had made best-effort attempts. The CRAs used advanced statistical models to gauge risk and derive ratings. With regard to the complex structured vehicles and mortgage-backed securities that were infiltrating the market during the pre-crisis period, model results were bound to be inaccurate. The reason was that models relied on analyses of historical data – but existing historical mortgage data did

not reflect the characteristics of the new types of high-risk mortgages which frequently collateralized structured vehicles. Additionally, ratings models traditionally factored in appreciating house prices. Data considering conditions of depreciating home values was sparse, since relevant data collection for the models in question occurred during periods of housing growth – quite unlike the housing bubble burst that was imminent at the time. In a New York Times article "Triple-A Failure" written in April 2008 (relatively soon after the mortgage crisis began), former Moody's MD Mark Adelson likened the CRA model input data discrepancies to "observing 100 years of weather in Antarctica to forecast the weather in Hawaii." Indeed, modeling with inaccurate models was quite pointless and ultimately served to add insult to injury. Furthermore, models incorporated quantitative assumptions so inaccurate that clients reached out to CRA employees with concerns. In one correspondence, an MD at Aladdin Capital Management noted to S&P, "I mentioned to you a possible error in the new Evaluator 3.0 assumptions: Two companies in the same Region belonging to two *different* local Sectors are assumed to be correlated, while if they belong to the *same* local sector then they are *un*correlated. I think you probably didn't mean that" (293). A client approaching a rating agency regarding mistakes in its own quantitative models is not only a bit laughable – it also indicates that competence was clearly lacking in CRAs as the crisis approached. Without appropriate inputs, ratings models could not have predicted the effects of the mortgage market collapse – even if employees had been sufficiently motivated to do so.

4. Mission/Strategy and Values and Competencies

The organizational trust elements of "Mission/Strategy" and "Values and Competencies" are so critical because the status of these elements pertain to organizational culture, and therefore have the broadest and most significant implications for the direction of the organization in

question and for the perception of its trustworthiness by every stakeholder. In “A Causal Model of Organizational Performance and Change”, authors W. Warner Burke and George H. Litwin address these organizational elements: “… in a large scale… Mission, strategy, leadership, and culture have more ‘weight’ than structure, management practices, and systems… Culture change must be planned as well as aligned with strategy and leader behavior. These variables have more weight because when changing then (i.e. organization mission), they affect the total system.” For instance, a firm with an unclear mission (or that acts in contrast to its mission), a secretive misalignment with stakeholder interests, and values that promote opacity, will likely have other questionable trust elements. Of every trust violation described in the Coburn-Levin Report, those of Goldman Sachs are most glaringly caused by organizational deficiency of these elements. An analysis of the previously mentioned trust violations shows how Goldman went out of its way to misalign its interests with certain clients for the strategic purpose of profiting from such misalignment. Even worse, the bank also had no qualms about going the extra mile to pull the wool over clients’ eyes. For instance, not only did Goldman not disclose its net short positions in the mortgage market to the clients to which it was marketing mortgage securities, it also deceptively marketed these securities. When Goldman circulated promotion about the $1.2bn Hudson CDO in October of 2006, it described the deal as “not a balance sheet CDO” (391), meaning that underlying securities were not ones being pushed off of Goldman’s balance sheet to prospective buyers. This was particularly misleading because, in fact, Hudson’s underlying assets *were* selectively chosen to offset ABX index risk on Goldman’s balance sheet. When Goldman marketed Abacus, of course, it never disclosed that it had structured the CDO to make a prominent hedge fund millions of dollars with investors losing as much while the market tanked. Another example of Goldman’s flagrant disregard of client interests in exchange for its

own is when the investment bank sought to maximize profits from its net short mortgage position. It did this by optimizing its position within the CDS market: taking massive short positions on CDS contracts and then taking long positions to cover the shorts and lock in profits once they reached a desirable level. In an effort to obtain more short CDS positions for less money, the bank decided to offer short positions on their existing long positions at arbitrarily low prices, placing downward pressure on the overall price of short CDS. Once the price was sufficiently low, Goldman planned to buy an abundance of additional contracts. It was a great proprietary plan for the bank – but a poor one for Goldman's clients who saw the value of their CDS contracts plummet due to the actions of GS. Senior bank managers were very aware of this fact. In May of 2007, GS employee Michael Swenson wrote: "We should start killing [single name] shorts in the street – let's pick some high quality stuff that guys are hoping is wider today and offer protection tight – this will have people totally demoralized" (426). With such a gleeful attitude about purposely devaluing other investors' portfolios (including those of Goldman clients), it might shock some to learn that Swenson was quite senior – the head of both the Structured Product Group and the Asset-Backed Securities trading desk at Goldman – and that he declared these sentiments in an open email. The trustworthiness element of benevolent concern is so absent in this case that the scenario seems to depict malevolent non-concern. As Goldman initiated its efforts to drive down the values of CDS short positions, one client, a trader at the hedge fund Stanfield, reached out via email to express what is clearly disappointment in the lack of trustworthiness the investment bank ultimately displayed: "I had always thought that these trades were meant to be the start of a partnership building of future business between Stanfield and Goldman Sachs. I know we are big boys and we did the trade there is no doubt of that… I've lost a lot of credibility on the desk with this trade. Maybe I was naïve to trust the pitch on the

trade. It has cost me a lot." (427). This client's words are poignant and human in the middle of a crisis (and an industry) that is often characterized by dehumanization. They demonstrate how Goldman allowed pillars of its organizational trustworthiness to falter amidst the ardent pursuit of monetary gain.

Similar to those of Goldman Sachs, Deutsche Bank's trust violations were also a result of the firm's failure to uphold a clear organizational mission and its failure to prioritize the fulfillment of client commitments. As previously discussed, Deutsche was a prominent participant in what employees call the CDO Machine. The bank appreciated the litany of hefty fees it could collect for the various roles it could take on in the underwriting and distribution of mortgage-backed CDOs during the boom in the subprime market. Deutsche trader Greg Lippmann was one of the earliest and most polarized dissenters with regard to the mortgage market as it began its decline, having a negative outlook on the mortgage-backed CDO market that the Report describes as "unrelenting" (350). As the head of the bank's CDO Trading Desk, Greg Lippmann was senior, experienced and certainly qualified to have an opinion on the direction of the CDO market. Logic says he was a man whose outlook a client would probably consider. Senior management did not heed Lippmann's advice – they remained net long in the mortgage market but allowed him to establish a $5bn short position from 2005-2007 (339). As the mortgage scenario grew increasingly uncertain, many knowledgeable market participants expressed surprise that mortgage-backed CDOs continued to be issued. Deutsche's Gemstone VII was one such CDO filled with RMBS securities that was structured even as the market began a downturn. Greg Lippmann asserted that many of these securities were faulty, but ultimately did not take any drastic steps to intervene when they were purchased for the Gemstone CDO. His views were not disclosed by Deutsche management to potential investors. The bank's marketers

simultaneously and aggressively rushed to sell Gemstone as the market came to the brink of collapse. In February of 2007, CDO Group co-head Michael Lamont wrote in an email: "Keep your fingers crossed but I think we will price this just before the market falls off a cliff" (366). This is quite an incendiary comment considering a man who understands the potential of a downturn is itching to sell a deal he thinks will see a steep and immediate decline in value. The urgency to structure sell a doomed CDO simply to collect fees and earn a profit certainly indicates a lack of concern for other investors. Clearly, Deutsche employees were almost panicked by the thought of not profiting from the sale of Gemstone. There's little indication of any consideration of the impact it might have on stakeholders who saw tremendous value loss. Perhaps Greg Lippmann himself could have also had more benevolent concern for investors in the marketplace. He regularly sent flippant emails like the one in August of 2006 when he discussed a shoddy security that came across his desk: "… That being said, I could probably short this name to some CDO fool" (339). However, Lippmann did advise his clients and his managers to take short positions in the market when he had the opportunity. Increased benevolent concern on the part of Lippmann's coworkers (particularly those members of Deutsche's sales force) would have resulted in full disclosure to potential investors of Lippmann's opinion and his large short position – even if such coworkers did not agree with it or understand it. Keeping that in mind, if the trustworthiness elements of communication and capability had been more integral in Deutsche's value system, both senior management and coworkers may have been more inclined to listen to Lippmann's perspective and perhaps increase their understanding by learning from him, rather than undercutting his outlook. If this had been the case, the bank, at least, would have been spared billion dollar losses.

Another, somewhat varied instance of a failure in these trust elements described in the Report is that of the Office of Thrift Supervision. Regulatory agencies have quite different roles than those of investment banks, but the case study of the OTS shows how losing sight of strategy and core values can prevent even a government-based regulatory agency from delivering on its commitments. In this case, misalignment of interests was a key factor in the trust violation, but the interests in question appeared in some cases to be stakeholder interests versus *personal* interests of senior OTS officials. The OTS served as Washington Mutual's primary regulator while the FDIC served as the bank's secondary regulator. There were obvious issues with the way the OTS approached WaMu's regulation – as previously stated, there was a culture of excessive deference to bank management and a passive tendency towards mere issue identification versus solution enforcement. This is one way an unfortunate set of values inhibited the OTS's performance as a regulatory agency. What was even more interesting was the reaction of OTS authorities to guidance and pressure by FDIC authorities. It was poor – the rapport between the two agencies became what the Report likens to a "turf war" (196). For instance, in response to mounting pressure to intervene in WaMu's situation by FDIC Chairman Sheila Bair, OTS Director John Reich sent a series of petulant emails saying things like "I can't believe the continuing audacity of this woman" (206) – he believed Ms. Bair had crossed the line by stepping over his head to make a recommendation without consulting him. One might hope that a regulatory leader would be able to look past his personal pride to serve a greater purpose of monitoring and enforcement for the sake of preserving the health of the financial system. This email correspondence occurred two weeks before WaMu failed. Had the OTS focused on its genuine mission, maintained interest aligned with stakeholders and developed effective lines of

communication with the FDIC, perhaps equity shareholders would not have lost so much value in the buyout by JP Morgan.

The aforementioned organizational trust issues may seem to overlap. For instance, the shortcomings of WaMu's compensation structure could also be shortcomings of Values and Competencies. The Burke and Litwin article presents a complex model of the elements of organizational performance – elements are represented by boxes, many of which are connected to multiple other elements by multidirectional arrows. In explaining the visual complexity of the model, the article states, "Arrows going in both directions are meant to convey the open-systems principle. A change in one (or more) box(es) will eventually have an impact on the others. Moreover, if we could diagram the model such that the arrows would be more circular – the hologram idea – reality could be represented more accurately." The authors are commenting on how, even if some elements carry more weight than others, factors that impact organizational trustworthiness are inherently linked together. With this thought in mind, this paper will now address recommended solutions of the Coburn-Levin Report.

IV. Interventions and Recommendations: Can They Restore Trust?

The trust violations that occurred throughout the financial crisis are multi-faceted and overwhelming. In response, Congress signed into existence the Dodd-Frank Wall Street Reform Act in July of 2010 – just under a year before the Coburn-Levin Report was issued. The bill's mandated regulatory alterations are sweeping and game-changing, especially relative to the issues discussed in this paper. In the case of the issue of High Risk Lending, Dodd-Frank bans stated-income loans and heavily restricts negatively amortizing loans and loans with deceptively low teaser rates. Federal bank regulators must also report on activities of insured banks and submit the reports for review. For this issue, the Report makes additional recommendations to

require banks to hold at least a 5% credit risk in all asset-backed securities it issues. Since Dodd-Frank doesn't entirely ban negatively amortizing loans, the Report recommends banks that issue these riskier assets should have more stringent capital structure requirements.

Regarding the issue of Regulatory Failure, Dodd-Frank entirely dissolves the Office of Thrift Supervision. It also revises mandates on the FDIC's regulatory role, giving the FDIC's Board more elective decision making power in choosing to conduct a special investigation if necessary. Also, the Act deems that banks with riskier activities should pay higher fees to the FDIC to deter risky activities and establish fairness in the insurance cost system. The Report makes additional recommendations – to hone the CAMELS Ratings system and to utilize in particular the Financial Stability Oversight Council (an agency that exists to gauge a financial institution's integral part in the health of the US financial system) to identify high-risk situations.

With respect to the issue of Inflated Credit Ratings, the Dodd-Frank Act pumped up SEC authority regarding CRAs, forming a new SEC agency in charge of overseeing only CRAs, giving the agency the power to discipline and fine CRA personnel, to deregister a CRA if ratings issued are inaccurate. Investors now have the authority to file private suit against a CRA if it purposely conducts substandard ratings research, and CRAs must establish their own internal controls to prevent ratings oversight. The Report additionally recommends the SEC to rank CRAs on accuracy of ratings and use its rights of inspection to monitor CRA operations to ensure ratings procedures are accurate and up-to-date.

Finally, addressing Investment Bank Abuses, Dodd-Frank restricts proprietary trading to only a few purposes such as market making for a client's new security offering. The Act also prohibits investments banks with large reserves of client capital (or those that are otherwise integral to the financial system) from using cash to bail out a private capital fund with which they may be

affiliated. Conflict of interest restrictions are also in place – to generally prevent banks from profiting from client losses and to specifically prevent any firm from issuing an asset-backed security and then taking a short position on such security. The Report recommends that proprietary trading restrictions be even narrower. It also stresses the importance of a federal regulator's knowledge of the complex universe of structured finance in order to understand and monitor investment bank activities in this arena.

In addition to these regulatory mandates, some one-off cases of justice (or attempts at such) for trust violations have occurred. For instance, the SEC charged Goldman Sachs with securities fraud in April of 2010. Goldman settled for $550 million, which may seem small when compared to the short positions it took on the mortgage market (and when considering the strategic lengths it went through to deceive investors). In fact, it is "one of the largest payments ever paid by a Wall Street firm to settle charges of securities fraud linked to mortgage investments" (Dealbook). In recent news, former Goldman trader Fabrice Tourre was found liable on six counts of fraud – the charges of which were brought on by the SEC at the same time it initiated the case against Goldman. Tourre was portrayed throughout the trial process as "a poster-boy for Wall Street greed and bad behavior", and has now ultimately been punished for his role in the Abacus CDO debacle (Gustin). Tourre's flamboyant antics – he has portrayed himself as a caricature of a stereotypical Wall Street sociopath with his flagrant and ridiculous statements – make it satisfying to see him brought to justice. On the other hand, personal accountability has scarcely been upheld post-crisis. Whether or not they are focused on in the Coburn-Levin report, the stakeholder public is very aware of a few mascots of this time of crisis – Rich Fuld of Lehman, Steve Rotella of Washington Mutual, Angelo Mozilo of Countrywide – high-powered Wall Street leaders who oversaw tremendous failures and walked away from the wreckage with more

money than most people can imagine. This widely-perceived injustice means that public stakeholder trust in financial institutions will be painstaking to rebuild.

While some aspects of justice in the aftermath of the crisis are certainly frustrating and disappointing, the mandates of Dodd-Frank and the recommendations of the report are well-considered and appear to address many of the underlying causes of the trust violations discussed: misaligned interests, lack of communication, lack of integrity, poor understanding and low capability. The ultimate question is whether or not these regulatory measures, once ironed out and perfected, will be able to restore stakeholder trust in financial institutions. The answer is uncertain, but thorough and consistent regulatory pressure where appropriate is an immensely viable solution to the complex multitude of issues that resulted in the financial crisis. The Burke/Litwin article describes a shift in culture and strategy as the most meaningful possible change an organization can experience. The article also asserts, "Organizational change, especially an overhaul of the company business strategy, stems more from environmental impact than from any other factor" (529). Looking again at Hurley's Organizational Performance and Trust Model (118), we see that Government is listed as an environmental force which impacts an organization's trust elements. In addition, Hurley also discusses how critical the trustor's perception of his own power is to his ability to trust (29). In this vein, the entire financial sector lends itself to be distrusted – especially by "Main Street" stakeholders to whom the entire industry is foreign. It is difficult for one to feel powerful in a relationship when he doesn't understand the counterparty's regular processes – confusion and vulnerability are more probable emotions. Many such stakeholders will never understand the nuances of Wall Street. Thus, laws are a great way to supplement power in the financial institutions' relationship with stakeholders, because a stakeholder can rely on regulations to protect his interests even if he is not capable of

doing it himself. Moreover, it's important to remember that in an environment where money is the most powerful and most relentless motive, it is more realistic to let regulations guide financial institutions and prevent employee transgressions than to expect industry employees to develop a sense of benevolent concern and self-control overnight.

The trust violations perpetrated by financial institutions onto their stakeholders during the crisis are exhaustingly complex and multilayered. A closer look at these institutions reveals how pillars of organizational trust had collapsed and how various elements of trustworthiness were grossly lacking in everyday functions and decision making. Actions during the crisis were so mindboggling and ultimate impacts so detrimental that rebuilding stakeholder trust will take significant time and effort. The Dodd-Frank Act of 2010 and the further recommendations of the Coburn-Levin Report may not be perfect, but their complete implementations will fulfill some key requirements of trust restoration: these regulations provide external pressure directed at several key trustworthiness shortcomings of financial institutions which facilitated the crisis, they curtail the compulsions of Wall Street employees to misbehave by limiting the freedoms associated with managing billions of dollars, and they permit the stakeholder to develop a sense of security and power which is an important prerequisite to a trusting relationship. Trust repair may be a painstaking process and the Report's regulations may not be flawless, but such regulations are the most realistic and thorough approach to eventually restoring stakeholder trust in financial institutions.

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