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Civil Society and the Reform of Finance

Taming capital, reclaiming virtue

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Civil Society and the Reform of Finance

Efforts to resolve the recent financial crisis have obscured a more deeply rooted financialization crisis that impacts not only the market economy but also the vital civic and moral traditions that support it. This book reveals the cultural influence of finance in reshaping the foundations of American civil society and proposes a return to certain "first principles" of the Republic to restore the nation's economic vision.

This book demonstrates how funding concerns and financial incentives "revalue" faith traditions, educational institutions, nonprofit organizations, and even the nation's healthcare system in ways that are eroding the diversity of American culture. These changes also undermine the ethical framework of both democratic government and the free market system. While financial influence has diminished the value of civil society, this book proposes that revitalized intermediary institutions still offer the best path forward in restoring the financial sector and, more broadly, enriching the American competitive ethic toward development of a more virtuous economy.

The book is written for an academic and professional audience, offering a blueprint for the involvement of civil society with government in providing more communally integrated oversight that could contribute to a genuine democratization of finance.

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Routledge Critical Studies in Finance and Stability
Edited by Jan Toporowski
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The 2007–8 Banking Crash has induced a major and wide-ranging discussion on the subject of financial (in)stability and a need to revaluate theory and policy. The response of policy-makers to the crisis has been to refocus fiscal and monetary policy on financial stabilization and reconstruction. However, this has been done with only vague ideas of bank recapitalisation and 'Keynesian' reflation aroused by the exigencies of the crisis, rather than the application of any systematic theory or theories of financial instability.

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Taming capital, reclaiming virtue
Charles McDaniel, Jr.

For Angus, Hambone, and "Mr. Fred," who helped me to see life in a whole 'nother way!

Acknowledgments

A book with an interdisciplinary approach to its subject requires an eclectic group from which to draw its resources. I have been fortunate in that regard. The diverse contributions of colleagues, students, business professionals, theologians, ethicists, and others with whom I have had countless conversations on the ethics of the financial system have inspired the material that follows.

Because of an aging memory (never particularly robust to begin with), I am at a loss to recall all the contributions, but certain individuals have given much time and intellectual energy to this project and deserve special mention. My colleague and friend, Dr. Les Ballard, whose diligence and attention to detail is extraordinary, was instrumental in helping me refine the manuscript. Les spent many late nights catching too many flaws in my writing and argumentation; he deserves some kind of medal. My former student, Dresden McGregor, joined the "team" after taking my capstone class in 2013 and contributed in countless ways up to the very day I submitted the manuscript to Routledge. Her keen eye for getting to the pith of arguments is a gift that will benefit her own work for many years to come. Another former student, Vance Woods, was willing to venture beyond his comfort zone in providing insights on a subject that, as will be seen, can be highly intimidating. Two other students, Anthony Severin and Cole Short, are moving on to bigger and better things, but they provided many imaginative ideas as well as important resources to help make the arguments that follow.

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1 Introduction

On a conference call with reporters and financial analysts in March 2012, JPMorgan Chase (JPM) CEO Jamie Dimon found himself apologizing for his company's "errors, sloppiness and bad judgment" stemming from a multi-billion-dollar trading loss in the credit derivatives market attributed largely to the actions of the so-called "London Whale," Bruno Iksil. Investigators uncovered evidence that led to JPM being fined around $920 million and two of its bankers being charged with conspiracy, wire fraud, and filing false reports with the Securities and Exchange Commission (SEC) even as the "Whale," because of his cooperation with authorities, was not charged.

Only two years earlier, Dimon had appeared before the Financial Crisis Inquiry Commission, lauding his company's performance in 2008 and 2009, the most challenging years of the crisis. At that time, he stated that along with its conservative accounting approach, JPM's decisions to not "unduly leverage" its capital and to maintain high-quality standards for investment enabled the company to remain strong and even to aid resolution of the financial mess by acquiring Bear Stearns and buying the assets of Washington Mutual.[1] JPM was perceived not merely as a survivor of financial calamity but as an exemplar of financial integrity.

So it was both ironic and embarrassing that the company thought to have weathered the maelstrom best, now had to assume the position of many of its competitors, appealing for public forgiveness and ensuring that all appropriate steps had been taken to prevent such losses in the future. Economist Paul Krugman was inspired to quote Yogi Berra that "it's déjà vu all over again" in suggesting the company's troubles demonstrated that few if any lessons were learned from the crisis commonly recognized as the most serious since the Great Depression.[2] Indeed, JPM's major transaction loss in 2012 was, in certain ways, more alarming than the losses leading to the initial crisis because it signaled that what many have suspected is true: the factors motivating risky behavior by large banks and investment companies have changed little. That it occurred during what turned out to be a profitable quarter for the company also reaffirmed the perception that giant financial firms can make money in spite of themselves.

Dimon's mea culpa hardly came as a shock to an American public already desensitized to financial mismanagement and rogue trading. After evidence surfaced of undisciplined acts that contributed to the crisis, the idea was that such "aberrant" behaviors could be controlled by tightening the regulatory noose and making the operations of financial institutions more transparent. Subsequent disclosures of the power of individual traders to jeopardize major markets, however, demonstrated that the need for institutional reform, so apparent in the lack of oversight that led to earlier abuses, had gone unheeded. Worse, it suggested the temptation to engage in risky practices that effectively used taxpayers as the ultimate insurance was more entrenched than originally thought. Dimon had earlier criticized the "Volcker Rule," designed to prevent the kinds of trading that precipitated the crisis, for its "mind-numbing complexity" even as it was revealed that his company engaged in the kind of risky investment practices the regulation was designed to restrict. While Dimon was correct about the inherent complexity in "postcrisis" attempts at regulatory reform, his criticism, which suggested the impossibility for regulators to distinguish hedging from proprietary trading, begs the question whether the industry is evolving beyond the capabilities of regulatory regimes altogether.[3] Regardless, the sad reality is that Americans are no longer surprised to learn of new financial scandals and have little expectation that those involved will pay for any transgressions, presuming that transgressions even can be discerned. What *is* truly shocking are changes that have flown largely beneath the radar but have far more serious implications for cultural, not simply economic, wellbeing. Evidence suggests financial influence, and in some cases corruption, reaches deep into American civil society—the network of nonprofit and voluntary associations that perform a critical mediating function between citizens and large institutions and are crucial to the development of both individual and social ethics. This book contends that the "financialization of American civil society" presents a more serious challenge than the recent financial calamity to the nation's long-term stability. In fact, the intensive effort to deal with the financial crisis appears to have further obscured a more deeply rooted "financialization crisis," one that has been building over decades and one that expanded regulation or even ethical reform of the financial sector cannot resolve.

Financialization refers to the continuous movement of capital from the production of real goods and services to the financial sector and the increasing dominance of financial values and interests in all institutions. It is a broad cultural phenomenon involving value changes that impact democratic capitalism's social and ethical structure. Financialization of the economy has negative consequences for macroeconomic stability and income distribution, among other effects; the financialization of "society," and especially that of civil society, has far more alarming implications for the continuation of the American experiment. It poses fundamental questions that require the involvement of ethicists, philosophers, educators, and religious leaders, who must locate appropriate forums for addressing the cultural effects of changes in finance, including the depersonalization of exchange, the distancing of owners from assets, and the growing divide in financial literacy.

More than systemic risk crept in undetected during the turmoil; these events exposed the global economy's vulnerability to the ethical integrity of key market players, many of whom failed the test. Despite the extensive development of administrative systems in both public and private spheres designed to support the financial economy, it appears more dependent on the personal ethics of individuals—including both executives and mid-tier workers in key technical positions—than ever before. These revelations suggest that even as finance has been characterized as failing the broader culture through fraudulent practices and rogue trading, the reverse may also be true. Traditional institutional supports that provide the moral framework for development may be failing to supply adequate ethical guidance necessary for a dynamic new financial industry in which moral quandaries proliferate alongside "innovative" products.

One reason for this systemic failure is that the same dynamism that challenges individual ethics also strains those institutions responsible for social and moral stability. Financial concerns are altering both the missions and values of religious groups, voluntary associations, and nonprofit organizations that help form citizens for self-government and protect them against exploitation by large impersonal establishments, both public and private. By reshaping civil society, financialization potentially undermines the cultural layer that supports the development of a virtuous citizenry. It is the consummate financial Catch-22: finance's incursions into civil society destabilize organizations that provide the moral framework for democratic governance and the market economy even as the methods and instruments it inspires place greater responsibility on individual virtue. The constant push for innovation in finance and the industry's importance to overall economic health seems only to heighten that exposure.

Recent scandals have revealed how the expansion of financial instruments beyond the comprehension of many market participants has negative cultural effects. These instruments and their associated techniques magnify information asymmetries, leading to an odd combination of market concentration within the financial industry and atomization of the financial marketplace, further widening the distribution of wealth and disenfranchising segments of society. In addition, resignation to the growing impossibility of "average investors" knowing what they own in any real sense due to the layers of financial interests and instruments involved in the investment process has the effect of alienating them from the cultural outcomes of economic behavior. The question is how to go about restoring and redeploying civil society to regain some of the responsibility for development that has been given over to dynamic new forms of investment.

A glaring example of finance's influence on civil society was revealed in 2014 with hedge fund mogul William Ackman's attempt to take down the Herbalife Company, a manufacturer and distributor of nutritional supplements. Ackman, the head of Pershing Capital Square Management LP, shorted Herbalife stock—a practice in which an investor "borrows" stock to sell with the obligation to buy back the shares in the future, anticipating the share price will go down—in what was effectively a $1 billion bet on the company's failure. Alluding to Herbalife as a "pyramid scheme" that targets minorities, Ackman vowed to use his vast resources and fight "to the end of the earth" to expose the company's practices, substantiating this claim by hiring political lobbyists and

PR firms to help accomplish his objective. In light of his activities, the *New York Times* stated that the "attempt to bring ruin to one company, is a novel one, fusing the financial markets with the political system."[4]

However, it is not only the political system that Ackman is using, and that is the more troubling relevance here. Ackman also deployed an extensive network of media companies and nonprofit advocacy organizations to advance his cause. As part of his mobilization against Herbalife, he has paid around $130,000 to civic groups such as the Hispanic Federation and National Consumers League to get them to lobby Congress and also to solicit their help in locating "victims," for which toll-free numbers were set up.[5] These groups sent letters that contained virtually identical language to their constituencies, which sought out those who may have been duped by the "abusive pyramid scheme" after being lobbied by Ackman's organization. Additionally, there is now evidence that Herbalife has outspent the Ackman campaign in this public relations war by contributing not only to political lobbying firms but also to groups such as the United States Hispanic Leadership Institute, a nonprofit committed to "non-partisan civic engagement."[6]

The point is not whether Herbalife is or is not a pyramid scheme or even whether Ackman is a civic-minded CEO or self-interested cad. It is rather that financial interests increasingly hold sway even over nonprofit, social service organizations formed to advance the public interest. Monetary inducements today are highly influential in those very institutions that are supposed to balance progress by offsetting vested political and economic interests. In this case, one powerful investor is determined to expose a company's presumed wrongdoing, using his immense resources to turn the outcome of a primarily financial transaction in his favor and co-opting civic groups in the process. And the company targeted has adopted similar tactics in a bidding war for the services of ostensibly nonpartisan organizations. Perhaps Herbalife will be revealed as a scam and Ackman will be vindicated, but the larger point is that public advocacy and community service organizations are being incentivized to take sides in financial "contests" between for-profit entities. This campaign crosses a boundary that has significant cultural implications should such practices become widespread.

One might counter with the argument that the Ackman-Herbalife controversy is an extreme case of financial influence. From the perspective of this book, however, that valid criticism highlights an even larger problem: the potential damage from the extension of big money into the civic realm and the need for American citizens to act to prevent it. The Supreme Court's decision in *McCutcheon* v. *Federal Election Commission* (2014), which struck down restrictions on "aggregate" giving by contributors to election campaigns while upholding limits on giving to individual campaigns, stimulated a vigorous public debate and became the fodder of late-night talk shows. Observing the new rules allowing donors to write virtually unlimited checks in limited increments, comedian Jon Stewart quipped, "the last great hope of preserving our democracy from the corrupting influence of money is carpal tunnel syndrome."[7] Where citizens are less likely to perceive financial influence is in the subtle changes in the values and relationships of civil society organizations, and likewise in the myriad decisions made in boardrooms and administrative departments that are often compelled to emphasize financial interests over mission.

Evidence will show how financial decision-making criteria increasingly "crowd out" others even in nonprofit, social service organizations. In many cases, a definite wall no longer separates the functions of for-profit from nonprofit organizations. Institutional homogenization is an underemphasized but significant byproduct of the financialization phenomenon. Finance is not portrayed as a malevolent force in this process; it serves merely as an efficient vehicle for capital formation and transference that facilitates, with similar efficiency, the potential reconstruction of social values. What particularly should concern Americans is the expansiveness and nuance of the means by which the financialization of civil society has occurred. Changes in the American competitive ethic are influencing many institutions to emphasize immediate financial concerns over issues that often are fundamental to these organizations' identities.

Just as scholars such as Robert Putnam have provided evidence showing that television and other forms of entertainment increasingly distract individuals from participation in civil society,[8] this book reveals an analogous form of "institutional distraction." Religious, educational, and social service organizations have become less focused on their missions and more invested in activities that affect their financial wellbeing. The combination of individual and institutional distraction is ominous for American civil society, and it amplifies the warnings of notable philosophers and economists who have warned that capitalism ultimately will exhaust its own moral resources.

While the ethical consequences of intensifying financial pressures are most easily observed in the banking and investment industries, other events of less monetary but greater cultural significance than rogue trading or creative accounting reveal the potential damage of finance's rising hegemony. Nongovernmental organizations (NGOs), preoccupied with budgetary concerns, are forced into cuts that are certain to impair services. Nonprofit healthcare organizations behave like for-profit entities, streamlining operations to solicit the investment attention of profit-seeking national healthcare systems. In other cases, healthcare nonprofits simply relocate to more affluent areas, chasing the insured and fleeing the indigent care needs of their communities and leading to what has been described as "medical white flight."[9]

Religious groups sometimes treat adherents as "clients," partnering with financial firms to market investment services. In some extreme situations, these groups act recklessly or even deceptively in attempts to further the interests of leaders or the organizations themselves at the expense of their members. Cases such as the New Birth Missionary Church in Atlanta, where members eventually sued the Church to recoup investment losses, or the Baptist Foundation of Arizona, whose leaders constructed an elaborate Ponzi scheme based on Arizona real estate that caused investors to lose $570 million, demonstrate the "religious" allure of finance.[10]

These troubling developments for civil society are not limited to the United States. In the UK, the clerical pension fund of the Church of England suffered major losses because of wildly speculative practices. According to pension consultant John Ralfe, the Church "just decided to go double or quits at the casino"[11] by investing in hedge funds and other volatile instruments. When the pension fund's losses became public, Church officials attempted to justify investments in hedge funds even though certain Anglican theologians had criticized the practice of short-selling (a common practice of hedge funds) as perpetrated by "bank robbers and asset strippers."[12] Anglican leaders rationalized their actions with an ecclesiastical take on "the ends justify the means," offering the statement: "Maximizing the returns on our investment portfolios is an essential part of delivering our foundations' missions, for the benefit of society."[13] In other words, even "sacred" institutions must at times engage in practices that may challenge their theological principles in efforts to achieve a greater good.

Examples like the aforementioned are increasingly common. Organizations, even those with primarily religious and social service missions, are becoming desensitized to potential conflicts between their professed values and their financial practices. As Randy Martin observes, "the present invitation to live by finance—which has survived the fizzled boom—is still being extended to players beyond the corporate world."[14] Many of those players find their once-privileged places in civil society threatened by a largely unperceived yet reckless *social* experiment driven by the radical expansion of finance.

The threat posed by financialization has been enabled by a curious ideal that formed surreptitiously in the American consciousness: the belief that a market economy can be separated from those social and moral structures traditionally thought to support it. Trust in the ethical resilience of the market system has encouraged inattention to those institutional supports essential to harmonizing material and moral development. It also contributes to a myopic focus on reason and technique in problem resolution. Technical reform of the financial system itself, however, tends to address the symptoms of reckless or unethical action rather than the root causes, just as it tends to expose the unintended consequences to government intervention. The Dodd–Frank Wall Street Reform and Consumer Protection Act and other efforts to "fix the financial system" have been largely mechanical attempts to put the economy back on track after its recent derailment, without considering the cultural implications of new financial techniques or potential moral hazards associated with reforms themselves.

A significant social cost of financialization posited here is that it collapses the nation's value pluralism and its traditionally inclusive view of progress into a singular obsession with "return." In addition, it seems to signal other changes in American society:

- The great material expansion from the period of industrialization through the late-twentieth century is waning, leading to more parasitic forms of money making;