The Securitization Machine and 2007 Financial Crisis:
How the Shareholder-Value Ideology of Corporate Bureaucracy Fooled Us Again

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Abstract

In this thesis I will argue that the major investment banks, by virtue of being bureaucratic corporations, not only allowed, but also required and trained, their individuals to convince themselves that self-interested and short-sighted actions were not a major risk for their firms and society at large. I explore this claim using the accounts of journalists and social scientists, and the theories of Max Weber on rationality and bureaucracy. The logic and language of the current shareholder value, played in important role in disguising the conflict, and is something that makes studying this crisis very difficult. The engine of crisis, the securitization machine, may continue on a new form, but there some people who have started recognize the dangers produced corporate bureaucratic thinking and shareholder value.

Introduction

It is difficult to get a man to understand something, when his salary depends upon his not understanding it!

-Upton Sinclair, 1935, I, Candidate for Governor: And How I Got Licked

The next pending crisis will no doubt exhibit a plethora of new assets which have unintended toxic characteristics, which no one has heard of before, and which no one can forecast today.... But if capital and collateral are adequate, and enforcement against misrepresentation and fraud is enhanced... Financial institutions will no longer be capable of privatizing profit and socializing losses.

-Allen Greenspan, April 4, 2010, Testimony to the Financial Crisis Inquiry Commission

I have had men watching you for a long time, and am convinced that you have used the funds of the bank to speculate in the breadstuffs of the country. When you won, you divided the profits amongst you, and when you lost, you charged it to the bank [of the United States].

-Andrew Jackson, 1834, addressing the Philadelphia committee of citizens

As Jackson's quote illustrates that the socialization of losses and privatization of profit is a problem that has plagued United States' capitalism for a long time. During economic boom times, privatization of gain is generally accepted as a necessary incentive for individuals who are promoting collective growth. During the crash that follows, though, the government covers the losses of businesses, and those who are most responsible are not always the ones who are held accountable.

Like the Great Depression, the causes of the 2007 Financial Crisis (also known as the Credit Crunch), beginning with the collapse of Bear Sterns, may never be fully understood or agreed upon. In both cases, determining the role of government regulations, central bank policies, and Wall-Street practices in causing the crisis, as well as how much greed and/or stupidity motivated these actions, is a politically loaded question. But, how much blame to give the actions of these actors is not the purpose of this thesis. It is clear that as result of their actions, the finance industry, specifically the top investment banks known as the 'bulge bracket firms', collapsed, taking the global economy down with them. These firms took such great losses that

the US government and the Federal Reserve spent in excess of 8 trillion dollars to keep them solvent (Ivry, Keoun, and Kuntz 2011). The 2007 crisis sometimes referred to as the Credit Crunch produced the greatest economic depression since the 1929 crash, which led to the Great Depression. In both these crises the losses were socialized.

Many, Alan Greenspan perhaps being the most public, have argued the crisis was unpredictable. As Sinclair reminds us, this is what we would expect from someone whose job it was to prevent such a crisis, and others who ran the banks and hedge funds that no longer exist (or were bailed out) because of the crisis. These people's jobs involve saying and often believing what they did before the crisis was what was best for themselves, their companies, and their stockholders even if it would seem obvious to any objective observer that they acted in a way to keep their jobs. This is what my thesis is grounded on: the understanding that ones job profoundly impacts one's perception and thoughts.

However, some financial professionals, insiders and outsiders, many of whom are chronicled in Michael Lewis's *The Big Short,* were well aware of the coming collapse. These people believe anyone who was paying attention to the economy should have been too (Lewis 2010). Lewis, among many others, suggests that willful ignorance and naiveté about the fraudulent or at least inaccurate rating and pricing of risk may have ultimately caused the crisis. But, it also created tremendous personal wealth for those who were able to cash out in time. In this thesis I will argue that the major investment banks, by virtue of being bureaucratic corporations, not only allowed, but also required and trained, their individuals to convince themselves that self-interested and short-sighted actions were not a major risk for their firms and society at large.

Bureaucracy and Toxic Waste

The conflict between individual and collective interest is one that social theory has long struggled to understand, and that countless legal and organizational structures have attempted to mitigate or control. Bureaucracy, broadly defined, is a way to organize a group to achieve its goals through the division and hierarchical control of collective labor using a system of standardized procedures and uniform policies. Exploring the details of this form of organization is the project of the first chapter. This system has dominated the organization of western societies. Bureaucracy can be tremendously effective at pursuing its goal, but the conflict between the individual and the group remains. So, we must understand who determines what is the ultimate goal of the bureaucratic organization. Those who run the bureaucracies often run it in their own best interest, rather than the interest of the organization as a whole and society they are a part of. Often producing disastrous consequences for all.

The collapse of the financial industry is in many ways analogous to the Fukushima nuclear power plant disaster, another crisis in another bureaucratic industry that resulted in a local disaster, which threatened to destroy the world. The Fukushima power plant produced toxic waste, which the plant could only hold in small quantities. The waste eventually needed to be stored in a safer location. However, because of the high costs of transporting the waste, the managers of the plant allowed the toxic product to bee stored at the plant in quantities far greater than intended. Additionally, the plant was built near an active fault line in a coastal region, meaning earthquakes and the tsunamis were inevitable.

All of the risks were seemingly accounted for. The plant was earthquake and tsunami proofed although only from a relatively small earthquake and they mislead the public and regulators about how much waste was being stored there. However, when the

earthquake/tsunami finally came, it was much bigger than planned for and the plant was not ready for it. It was severely damaged and threatened the world with toxic radiation.

Despite the lack of adequate preparation for a seemingly inevitable disaster, it seems highly unlikely that the corporation that ran this plant wanted to it to meltdown. Rather one could imagine that those running the corporation had decided that the cost of paying for the damage was less than cost of preparing for the disaster. These costs are not just the economic risks and costs to company, but the costs and risks to the individual who points out this situation.

In the financial industry, the equivalent of a nuclear power plant is the securitization 'machine'[1]. It uses various types of loans based on home value (and eventually bets about homeowners ability to pay those loans), which it turned into a product called mortgage backed securities. Mortgage backed securities worked on the premise that insecurity was reduced when individual mortgages were bundled together. However despite the seemingly beneficial purpose of the machine, like the Fukushima reactor, the securitization machine used by most banks contained many shortcuts. It created quick, seemingly risk free profits for the bankers and their bosses, so long as housing prices continued to rise, and no one looked at the details of the loans. This of course transferred incredible risk to those who bought the products, and homeowners, but the banks were "protected". Banks were only seemingly protected, though, because, like the nuclear power plant, banks kept the toxic waste, mortgage backed securities, longer than was originally considered safe. Banks also recycled the most dangerous portions, which was even harder to rate or price, making the inevitable crisis/the meltdown much worse. The risk for individuals who ran the machine was minimal, so long as they made sure they were not around when it blew up.

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1 It is not an actual machine, but legal process/procedure

2 By ground in social action, I wish to distinguish from the notion of Embeddedness, which specifically refer to

While nuclear and financial engineering are very different industries, these two crises played out in very similar manners because of one common element: bureaucratic corporations control both industries. This form of organization supports the privatization of gain and socialization of losses, thus, maximizing the gain and minimizing the risk of those who run them. This is to say that what corporations were originally created to do, improve society, has become at best a secondary goal, and at worst, a hollow marketing ploy.

Bureaucratic corporations train people to not only accept, but to support the belief that collective failure is an unpredictable and inevitable risk of business/economic growth and that no one should be held solely responsible for these failures. Because of the nature of bureaucracy, someone, likely the wrong person, will be used as a scapegoat to take the blame for the whole company. They are taught to accept that is an unfortunate and unavoidable but necessary part of doing business and that on the whole, society and the corporation are better of because of it. When a failure occurs, underlings are blamed for superiors mistakes, and when a success occurs, the superior takes the credit. While luck and skill in one's official capacities play a role in success. In general, those who wish to advance up the corporate later must refine their to ability avoid responsibility, blame others for their mistakes, and above all else, use the appropriate defense/explanation for their actions. This appropriate defense of action is defined in large part by something called a conception of control.

A conception of control, a term coined by Neil Fligstein, refers to the framework corporate actors use to understand and explain their world, based on common understanding about the best way to run to corporation. This framework helps actors make sense of their confusing and constantly shifting world, and to decrease the uncertainty that is inherent in it. Historically a conception of control has been linked to a specific set of best practices, however the current conception of control, shareholder-value, has proved incredibly versatile.

Bureaucracy and Shareholder Value

For reasons that will explored in chapter 1, since the 1980's, corporate bureaucracies, have latched on to the idea that the only legitimate purpose of corporation is to create value for their owners, the shareholders. This chiefly means increasing quarterly, or even daily share price is the ultimate goal of the corporation. Under the shareholder-value conception of control, any action taken by management, or their employees is good if it increases the share price. It is versatile because it allows for one goal, shareholder value creation, to be seen as something that is consistent with the interests of employees, owners, and society. The details of how this plays out in investment banks will be explored in chapter 2, but as one can see, this framework leaves little room for evaluating long-term implications of decisions for the corporation, or the societal impact in any time frame.

The shortsightedness and self-interest that led to the crisis has been attributed to an immense variety of structural, cultural, social and economic factors. However, based on my understanding of bureaucratic corporations and the shareholder value conception of control, I am certain those responsible will work to blames others, obscure the truth, and/or frame the crisis as technical problem that affected everyone; to argue that no one could understood the situation that had been created, the extent to which banks were connected, the true size of the risk they had taken on, and perhaps more importantly the degree of fraud and misrepresentation in the mortgage market and the ratings/modeling of the structured products derived from it.

In chapter one I will explore the dynamics of corporate bureaucracies using the theories of Max Weber and Robert Jackall and Fligstein's conception of control, specifically looking at how the shareholder conception fits into this model of the bureaucratic corporation. In chapter 2, I will look at how theories of the bureaucratic corporation and shareholder value can be applied to investment banks and financial crisis based on research of Karen Ho and Donald Mackenzie.

In chapter 3 I will explore the crisis in greater detail, using Journalistic accounts of specific events evidence of this theory and expand upon what how it can help us better understand the crisis. In chapter 4, I will look at a sampling responses to the crisis that offer in sight into how bureaucratic control and shareholder value have responded, and the failures that have been identified.

Chapter 1-Corporate Bureaucratic Control

The U.S. and most other G-7 economies have been significantly and artificially influenced by asset price appreciation for decades...Growth, in other words, was influenced on the upside by leverage, securitization, and the belief that wealth creation was a function of asset appreciation as opposed to the production of goods and services. Americans and other similarly addicted global citizens long ago learned to focus on markets as opposed to the economic foundation behind them...[in the two decades after 1956] we were getting richer by making things , not paper. Beginning in the 1980s, however, the cult of the markets, which included the development of financial derivatives and the increasing use of leverage, began to dominate.

-Bill Gross, Midnight Candles, November 2009

Bill Gross is summarizing a widely held opinion on how investment banks, as the leaders of the "cult of the market", began to control the global economy. But, this opinion only captures part of what is going on. The increasing focus on stock prices and financial evaluation in the 1980s helped Wall-Street (or the collective investment banking industry) come to power (Fligstein 1990). It was also during this period, that Wall-Street firms, which were previously smaller and employee owned, came to be bureaucratic corporations. The 'cult of bureaucracies' is what Jackall feels caused the greed and short-term focus, which I argue was largely involved in the 2007 crisis. This is similar to the 'cult of the market' discussed by Bill Gross who feels this greed and short-term focus can be seen in the use of derivatives and leverage in the 1980s. However greed and short term focus were themselves a result of the what we might call the 'cult of bureaucracy' and its latest, idol shareholder value. In these chapter I will explore how useful shareholder value creation is for corporate bureaucracies, and how it masks the conflict between the goals of those who run the corporation and those who own it.

Shareholder value draws on economic theory about the efficiency of markets. Thus, it is important to distinguish between how sociologists and economists conceive of markets and the people and organizations involved in these markets. Economic sociology is based on the hypothesis that markets, and indeed all of economic activity, is grounded in social action[2]. Using

2 By ground in social action, I wish to distinguish from the notion of Embeddedness, which specifically refer to

the framework of social action allows us to understand the differing social constructions of efficiency, and efficient organization, through time and space. It also allows us to examine the relationship between individual, organizational, and societal behavior to decision making[3]. Following the groundwork lay by Max Weber, the actions of organizations and societies are understood by a belief in rational individuals whose individual actions are the 'atoms' that make up organizational and societal processes. Rational means that individuals have ends, or goals that were pursued and achieved using the means the individual believe is most likely to achieve those ends.

Rational does not mean quite the same thing in sociology as economics. Sociologists, unlike economists, believe that individuals exist in larger social structures, which color their perceptions and values and determine what ends and means are seen as viable and/or socially acceptable. Weber identified bureaucracy as the organizational structure that came to dominate and define capitalism in Western societies in modernity. Bureaucracies have to ability define the social world by rationally organizing people to pursue a goal. Its power is thus knowledge based. By standardizing and controlling the application of its knowledge to produce a formal rationality (if x then y), bureaucracies could not only organize people more efficiently, by eliminating the need for time-consuming and confusion producing critical thinking, than other methods, but also by making the evaluation of alternatives an almost impossible task.

This is distinct from the perspective of economists where the individual is a rational utility maximizer for whom social structures are means to achieve the end of maximized utility, an abstract objective measure of usefulness. While there can be no doubt that economic theory has produced incredible material wealth and growth, and that much of modern business activity

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idea that economic relations exist in context of social networks (Granovetter 1985)

3 It worth noting not all economic sociologists believe efficiency is a social construction, though they still contest its usage by economists to explain economic life. (again see Granovetter 1985).

could not exist without the use of formulas and positivist assumptions, its conception of society or economic action is still incomplete. Their analysis is driven by the belief that market processes are not social. Rather they are driven by considerations of efficiency. Therefore in a market, more efficient forms of organization will emerge as time passes. This is known as the efficient market hypothesis. As was previously discussed, efficiency is a social construction, and bureaucracies have the ability to largely control social action and thus markets and economies.

Robert Jackall and the Corporate Bureaucratic Ethos

Robert Jackall's *Moral Mazes* uses theory drawn from Weber to understand how corporate bureaucracy shapes the construction of efficiency as well as the thoughts and beliefs of the people who run it. Jackall's book, an interpretative sociological account of how corporate managers think their corporation works, was based on a series of interviews and participant observations he conducted at large corporations in the early 1980's (Jackall 2010, 9-10).

Jackall contends, drawing on Weber's model, that bureaucracies, are "institutionalized paradigms of functional [formal] rationality" meaning that "technique and procedure tend to become ascendant over substantive reflection about organizational goals" (Jackall 2010, 80). The dominance of formal rationality, or what Jackall calls functional is the strength of bureaucracies and also what enables them to control individuals' evaluations. Because this formal rationality is about the standardization of technical process, they are often a useful way to address failures.

When formal rationality fails, though, corporate bureaucracies are forced to use critical thinking. This type of rationality is called substantive rationality. For Jackall substantive rationality is "critical reasoned reflectiveness with which one assesses and evaluates particular goals themselves and which guides ones decisions"(Jackall 2010 80). This type of thinking allows one to consider the broader consequences of decisions and sometimes to pursue new goals

and/or produce new processes. It allows one to step outside of the demands of bureaucracy. But it can also be dangerous. How and when it is applied highlights the divide between the goals of the organization and of those who run it.

When forced to pick between their interests and the interests of the firm, corporate managers often pick the former. “Managers know that even farsighted, correct decisions can shorten promising careers”(Jackall 2010, 89). Therefore, they are not simply choosing between themselves and the corporation, but between having a job or sacrificing their jobs for the sake of the corporation. As a result, when decisions that would protect the long-term health of the firm are set against one's own advancement or being let go, managers almost always choose to advance or keep their jobs (Jackall 2010, 80-85). Thus for corporate actors, at any level, “the real issue is....who is going to get blamed if things go wrong” (Jackall 2010, 89).

While it might seem strange managers must make this decision often, especially with the increasing role of technology and financial measures to track performance, the bureaucratic corporation is full of uncertainty on what actually is the best interest of the corporation. Even in situations where there are quantitative measures of success or failure, Jackall finds inter corporate bureaucracy politics, or who you know in a position of power, is much more important in deciding where credit and blame are assigned (Jackall 2010,89-90). As a result, written documents and accounts of corporate events are only “official versions of reality” giving no indication of the complexity and ambiguity of political processes that result in a given series of events (Jackall 2010, 89).

This ambiguity gives those who put their own success ahead of the corporation the ability to outrun mistakes' their mistakes. Jackall observed a tactic known as 'milking', which is where managers intentionally sacrifice the long-term health of the corporation for their own short-term gain (Jackal 2010,93-96). This is done by increasing financial ratios by any means

necessary, regardless of legal or social consequences. In the manufacturing plant that Jackall studied this meant "reducing assets while maintaining sales" (Jackall, 2010, 96)[4]. It was done by only investing enough in money manufacturing plants to maintain short-term production. The inevitable consequences of this lack of maintenance resulted in the plant halting production or even failing. However if the employees' excellent performances and/or political connections allowed them to be promoted to higher positions before the plant failed, they could blame whoever was currently managing the plant. Similar things can be seen in many bureaucracies: unless someone is willing to sacrifice their career, or some external party forces it, only the minimum spending will occur. In many cases the cause of failure is linked to a previous manager's actions, but if he or she now has the political power to blame the current manage he will produce any necessary documentation that frees him from blame (Jackall 2010,96-100) When the manager has advanced to the top level of management, such documentation is not even needed and the manager can "tough [the crisis] out with sheer brazenness" (Jackall 2010, 100).

Jackall concludes his discussion of this behavior by noting that this "take the money and run ethos, of short term gains, outrunning mistakes and leaving problems for others" can constrain managers who want to find balance between their interests and those of the corporation (Jackall 2010, 105). Despite their best attempts to use "substantive rationality" to protect themselves and to look out for the corporation, it is impossible. Their actions will inevitably produce disastrous results for the firm (Jackall 2010, 101, 105-106).

In order to protect themselves from such crises, and advance, managers learn that controlling the perceptions of one's peers and superiors is the key to ensure positive evaluations. The power of these groups is that they not only assess current performance but also downgrade the perceptions of past performance (Jackall 2010, 89). As a result, managers are forced to focus

4 Jackall 96, the main ratio is return on assets, a measure the revenue produced relative to the assets of the division, similar metrics such Return on Investment or Return on Equity used to evaluate banks

on short-term goals to maintain positive relationships, and ignore the long-term needs of the corporation.

In addition to building these relationships, corporate managers must learn to recognize dangerous situations they are being drawn into and learn different ways of preparing a sufficient defense (Jackall 2010, 89-90). The strategies used to do this are colloquially known as 'cover your ass' preparations" or CYA (Jackall 2010, 90). CYA involves the mastery of the ability to talk in circles while saying nothing and involving as many people as possible in decisions so one can share the blame (Jackall 2010). Involving others in decision-making is part of the political process, but it is these people's use of language, and how it affects their sense of self and perception of the world that is most interesting.

Managers become masters of what Jackall calls provisional language, is a language whose meaning is specific to the needs of person using it (Jackall 2010, 142). The purpose of this language is to" communicate certain meanings within specific contexts" because "there is an implicit understanding that should the context change a more appropriate meaning can be attached" (Jackall 2010, 142- 143). Just as the official written version of events can change, there is even greater fluidity in verbal communication. Managers learn to deal with "the manufacture of multiple ideologies and mythologies" (Jackall 2010, 155). Knowing which of these corporate ideologies/mythologies to pursue with formal rationality is then substantive rationality applied to one's own goal of career advancement. However one must appear to be applying rationality (of either type) in the interest of the corporation, and thus master the language of the bureaucratic corporation, and its values in order learn how to disguise this self-interest.

Jackall finds that individuals attempt to understand these through mythologies from a variety of sources in order to have the the greatest possible flexibility in their CYA preparations. These sources, the "semi-official viewpoints disseminated through the impressive

communications apparatus common to all bureaucracies" include "monthly employee newspapers, news brief circulars, daily news sheet summaries for executives... as well official pronouncements" (Jackall 2010, 155). Mastery of this doubletalk and doublethink, coupled with making the right friends, are the key determinants of who advances in the firm.

This double talk gives managers verbal dexterity, "the ability to "throw people off the track" but it can also be confusing to the managers themselves (Jackall 210, 154). Jackall found it was common for managers to become lost in the "tangle of ideologies, perspectives and view points become inconsistent in at least their explanations of reality even over a very short period of time" (Jackall 2010, 155). As one manager notes, somewhat jadedly, "[high level managers and executives] will switch explanations of things from day to day and not even notice" (Jackall 2010, 155). Managers become adept at using different vocabularies to explain the same event. This is accepted so long as employees can adopt the official line on important events and are skilled enough to follow social custom and avoid being called flaky by switching too often in the same group. (Jackall 2010, 155).

As managers advance actually begin to believe this language. Corporate managers must learn to "tailor their public faces to suit the fashions of the moment"; perhaps more importantly, to tailor their "habits of mind to match the institutional logic of their organizations" (Jackal 2010, 202). This process of "voluntary self-rationalization produces the deepest internalization of their organizational world" and separates them from any sense of morality or reality that might exist outside of this world (Jackall 2010, 202-203). Thus, to succeed in the bureaucratic corporate world, once must internalize its ethos or values, and at least at work, believe them.

Jackall generalizes the acceptance of this ethos as the acceptance that the inconsistency between what one says, and what one actually does, is not a meaningful or important difference, and is required so as to do what needs to be done. This enables one to support the privatization of

profit and the socialization of losses, the take the money and run ethos. While "publicly demanding increased self-regulation of industry" many will "privately acknowledging that the competitive welter of corporate life and of the market consistently obscures attention to social needs" (Jackall 2010, 171). Though Jackall does not make this point explicitly, this does not have to be contradiction if one believes that benefits from industry to society outweigh the costs. One must accept that these costs are necessary part of doing business. As a more generalized value, it is accepting that the belief that "the real problem of our society is unwillingness to take risks" is consistent with believing that corporate bureaucracy, a system where "one avoids risks at every turn" and when risks are unavoidable makes sure they if turn out badly, someone else in the corporation, the corporation itself, or ideally someone out outside of the corporation, will suffer the consequences of your risk (Jackall 2010, 171). The corporate ethos, conceptualized as the acceptance the need for the hiding mistakes and separating consequences from actions, individualizing success and socializing failure, exposes the gap between individual and organizational goals. However, if it could made consistent with ends the owners of the corporation or society at large, or at least made to appear so, then the ethos, and those its supports, can remain in control.

Bureaucracy and the Role of the Conception of Control

In his 1990 book *The Transformation of Corporate Control,* Fligstein shows that the financial evaluation that Jackall observed was part of a larger and more complex force than Jackall realized. Sharing Jackall's belief that notions of efficiency and best practices are socially constructed, Fligstein suggests that the mythologies and ideologies of the corporation that help mask the divide between managers and owners, also support the corporate ethos. However the

format these mythologies must follow, and the language used to justify actions is not just dictated by the whims of top executives (Fligstein 1990). They are determined by an interpretive framework called the conception of control, a socially constructed view of the most efficient way to run a bureaucratic corporation. Fligstein's initially defines the conception of control as:

> World views that define one firm's relationship with others, what appropriate behavior is for firms of that type, and how those kinds of organizations ought to work. They imply certain strategies and structures…they create define how markets are structured for firms (Fligstein 1990, 296).

Fligstein's central argument is that managers and owners seek to influence the social construction of economic efficiency in order serve their own interests and maintain control (Fligstein 1990). Like other economic sociologists he believes the abstract model of efficiency is flawed. The economic model, based on market forces that lead to increasing efficiency, allows an abstraction of "the market" to fit neatly over complex and contested social patterns of organizational change. Fligstein contends that the central flaw of the abstracted efficient market is that "economic historians have known how things turned out… and thereby were able to impute what kind of social institutions must have been called forth by efficient markets" (Fligstein 1990, 300). By exploring the socially constructed nature of efficiency, Fligstein exposes how managers and owners work to "impose their view of a sociologically efficient organization of markets on others" (Fligstein 1990, 296-297).

Fligstein terms his analysis the political-cultural approach, whose major feature is "to consider that social action takes place in arenas, that may be called fields." (Fligstein 1990, 297). Fligstein's analysis is grounded in institutional theory and Bourdieu's concept of a field. In the case of corporations, arenas are organizational fields, which view organizations as inextricably embedded in a larger network of interactions through structures and actors.

Fligstein sees markets as containing multiple organizational fields, though since the 1960's, large corporations and banks have all been part of a single organizational field (Fligstein 1990). In contrast to economic theory, Fligstein offers a definition of markets set forth as a "self-reproducing role structure of producers" (Fligstein 2001, 17)[5]. The market thus only includes the producers, not the buyers. The producers seek to find stability in their interactions with competition, not to maximize profits, but to ensure the survival of the firm. This stable relationship does not mean there is no competition. Rather the goal of managers is not profit maximization but reducing uncertainty to ensure firm survival (Fligstein 2001, 17). They are looking for some form of predictability so they can exercise formal rationality.

His theories about the role of power and control in corporations are similar to Jackall's theories. But instead of looking at internal interactions between corporate managers, he is applying them to interactions between firms in an organizational field. In these fields, actors seek to produce a system of domination and stability, through the establishment of "a local culture that defines local social relations between actors" (Fligstein 1990, 296-300). This local culture is part of the conception of control. The dominant groups in firms design benefits and rules and use these to reproduce their power, thus making the determination of cultural norms a political process (Fligstein 2001, 15-16)[6]. This directly mirrors the internal dynamics of the bureaucratic corporation where powerful interest/hierarchy allow one group to impose its version of reality on the other.

Like the corporate bureaucracy itself, the conception of control is subject to upheaval during a field wide crisis. A crisis, whether caused by larger economic conditions or changes in

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5 Fligstein takes this definition from James White. I should not that in modern corporations, especially those in the financial industry the division between producers and consumers is much more fluid than Fligstein's definition allows.

6Here political refers to political process of negotiation between different companies and the government.

regulation, is a moment of instability and great uncertainty. Thus, it is a situation where the conception of control must be abandoned or modified (Fligstein 2001, 65). Before looking at how the current conception of control (and the one Jackall witnessed the emergence of), shareholder value, came about, it is worth looking into the conception that preceded it, the financial conception, because shareholder value was produced as a result of an inability to handle a crisis.

From Crisis to Crisis: Financial Control to Shareholder Value Control

The crisis that Fligstein studied resulted from the Celler-Kefauver Act of 1950 coming into place. This is also when financial control of corporate activity emerged (Fligstein 1990, 228). This act, coupled with an increasing number of managers who were trained in business school and financial theory, produced tremendous growth for their corporations (Fligstein 1990, 228-230). It meant corporations could no longer easily expand by mergers and acquisitions (M and A) of other companies in the same industry, as they had under the previous conception. This led to emergence of a new form of bureaucratic organization, the multidivisional conglomerates, and the financial conception of control (Fligstein 1990, 229-230).

The financial conception of control said the actions of a corporation or a division should be rated by their ability to produce growth of profits. The antitrust law still allowed managers to use M and A, but only with companies in different industries. Thus unrelated mergers (or unrelated diversification) became increasingly attractive by enabling easy growth. This led to the formation of conglomerates: large bureaucratic corporations that spanned many different industries. Managers trained in accounting and finance were used to evaluate the effectiveness of these M and A. since the financial conception of control allowed them to evaluate companies

solely on their financial gains. Corporate managers trained in accounting and finance used "measures of financial performance...[such as] stock price and price/earnings ratio" to achieve great success (Fligstein 1990, 297). The Multidivisional or M-Form was well suited to this task. This form of bureaucratic organization had a central office that acted like a central bank to administer the different divisions. This "central bank" worked by evaluating financial efficiency and providing financial guidelines based on a divisions' contribution to the firm's overall financial health (Fligstein 1990, 228).

The pioneers of conglomeration "perfected the strategy now called the leveraged buyout" (Fligstein 1990, 248). They helped invent the "financial innovation" described by Gross in the epigraph by "inventing many of the financial manipulations that dominate in large firms today" (Fligstein 1990, 247). Despite the discourse that would emerge about how conglomeration hurt shareholders, the stated goal of this shift was to ensure that management would "build value and increase earnings per share"(Fligstein 1990, 247). This conception is superficially identical to the rhetoric of shareholder value that revolutionized Wall Street in the 1980's and 90's and is evidence of how social construction of efficiency changes based on the needs of those who control bureaucratic corporations.

Despite this, Fligstein contends that conglomerates' spectacular growth was only a product of "financial manipulations." This hides the fact that conglomerates were not built to maximize profit but rather pursue asset growth through increasing debt (Fligstein 1990, 292-294). The only way to support such debt was through expansion, allowing it to maintain and conceal its "spectacular growth with low profitability" (Fligstein 1990, 292). In theory this type of firm was allowed to maximize efficiency and generate profitably through economies of scales. But in reality there were practical difficulties in integrating companies (Davis, Diekmann and Tinsley 1994, 553). Organizational economists justified the conglomerate as efficient for its

ability to run undervalued companies more efficiently through better management and internal financial controls. (Davis, Diekmann, Tinsley, 1994, 553-554).

The 1980's saw the end the conglomerate as a viable strategy for corporate growth and a denouncement of the virtues of unrelated diversification. The relaxation of anti-trust law and general deregulation under Reagan's Neo-Liberal economic polices and the gradual repeal of the Glass-Steagall Act helped create this crisis and lead to the emergence of the shareholder value conception of control.

The shareholder value conception of control uses economic theory to suggest that it is the duty of managers to maximize the profits of those who own the firm, the shareholders. It uses this theory to suggest not only that "the only legitimate purpose of firms is to maximize shareholder value" but also that doing so is also in the interest of society as a whole (Fligstein 2001, 148). Shareholder value is ultimately a measure of success in share price of the firm. Thus like the financial conception, which only focused on profit, with the shareholder value conception, manager's only need to pay attention to stock price and its relationship to debts/equity earnings ratios (Fligstein 2001, 126). However the shareholder value conception is based on agency theory, a conception of economic activity derived from the legal definition of a corporation that is popular in economic modeling.

The model of the corporation under agency theory is that it is a contractual relationship between two types of individuals with different interests, the owners or principles, and their appointed agents, the managers/employees of the firm (Fligstein 2001, 174). Agency theory seeks to understand what incentives principals, stockholders, or their representatives, the board of directors, can use to align the incentives of managers and owners (Fligstein 2001, 126). Recalling our definition of the corporate ethos, this does seem like a useful perspective that speaks truth to the nature of a corporation. However it does not account for the extent to which

managers become skilled in accounting and financial theory, as well as the use of provisional language order to disguise this conflict.

The firm then is a "nexus of contracts", and it is no different from the larger market in which it participates (Fligstein 2001, 174). The specific form of organization a firm takes then is only a result of agency cost involved in setting up and enforcing the contracts (Fligstein 2001, 175). In the case of the corporation, there are three contractual features: the linkage of managerial pay to stock market performance, the ability of boards of directors to sanction managers, and the capacity of the market to buyout firms that have been mismanaged. These features ensure the arrangement is efficient (Fligtein 2001, 175). Different theories exist about the specific forms of organization which exist, specifically whether organization is path-dependent (dependent on some initial advantage that gets "locked in" at equilibrium) or if they are continuously evolving in a feedback loop (Fligstein 2001, 176).

It is clear that to succeed, corporate managers in all firms must navigate a complex social power structure, internalize both its values and the values of the conception of control, and master a provisional language to mask the difference (Jackall 2010). Actors in corporations (managers) are constrained to thinking and acting according to the norms of this process and even ethical decisions are subject to the ethos of a bureaucratic firm. This ensures mangers seek to apply functional rationality whenever possible and are guided by the 'correct' value system when applying substantive rationality.

Before exploring the role of this ethos, and bureaucracy in financial crisis, it is important to discuss one's guiding ideology that Jackall did not have the perspective to grasp, the shareholder value conception of control. While details of these mythologies are idiosyncratic to the firm in question, they are increasingly backed by neoclassical and financial economic models, assumptions, and worldviews. Understanding the larger ideology and its purpose, as

well as its idiosyncratic details (that is industry, firm, division or even working group specific iterations) are essential skills for managers (Fligstein 1990).

The goals of formal rationality are fixed and regularly reformulated based on the dictates of upper management, while maintaining consistency with the conception of control through the use of a contextual doubletalk termed provisional language. This language, and the conception of control, allows executives to hide that they govern organizations for the benefit of themselves and those in their inner circle. This is an understood fact in the organization that cannot be acknowledged, so they surround themselves with those who demonstrate they understand this fact as demonstrated by their internalization of values and loyalty. This loyalty is measured by one allowing senior managers to take credit for ones successes, and taking the blame for the superior's failures, or assisting them in finding a scapegoat. Thus there is a disconnect between performance and pay/reward actions and consequences. This in turn results in managers seeking to outrun their mistakes, and preparing to protect themselves from others failures. Substantive rationality is exercised by upper management in theory. But they have learned through the experience of advancement that substantive rationality is hard to assess in the short run and subject to interpretation, which means it can result in personal damage even when it is in the best long run interest of the firm.

Thus the new conception, shareholder value, despite its attempt to address the conflict between manager's corporate ethos, the interests of society and those who invested in the firm, was still able to allow manages to apply functional rationality and substantive rationality consistent with their value system.

Banks and the Structural Change of Corporations

As a result of shareholder value, corporations' bureaucratic organization changed from a multi-divisional company to a subsidiary model that helped managers hide the conflict between

their interests and those of the corporation. The Multi-Divisional form did not go away but underwent an important legal shift as a result of addition of a new layer of separation from upper management and production management. This form was first adopted by large banks/ the financial industry (Zey 1999, 50-53). Zey found that the Multi-Layered form has several advantages over a Multi-Divisional form, and this form enhances and promotes the fraud networks of the 1980's. The MLS form decreases the liability of the parent or holding company, or the central bank/management office. It allows greater financial/accounting flexibility. [7]

Zey was attempting to understand how the actor networks of the individuals accused of fraud in 1980's S&L crisis were related to the organizational form of the firm. She found the subsidiary model with its detached and flexible management was especially compatible with fraud. Although I discuss it abstractly now, this crisis will be further explored in chapter 2. Zey suggests that the key to understanding securities fraud is the complex relationship between the fraud networks and the structure of firms within the organizational field (Zey 1999, 64). It is not surprising that she finds that the organization of securities firms and culture of investment banking helped conceal securities fraud, as this is consistent with CYA dynamics and value system of the corporate ethos. As a result, while Zey can conclude that the multilayered subsidiary form "greatly enhanced the securities fraud the 1980"s it is unclear if this was the intended goal of this form of organization (Zey 1999, 70). However, in light of the findings earlier about the corporate ethos, it appears likely that if fraud improved profits, and can be seen as similar practice to milking, we would expect both that the individuals ultimately prosecuted for the fraud were scapegoats. It may also have bee an excepted practice that financial reorganization was designed to facilitate, and even the language obscures this motivation.

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7 Zey 59-62, note Zey uses the term Multiple Subsidiary Form and others Multi-Layered SF but given that she contends its value is derived from the structural holes between legal layers, I feel the inclusion of layers is more accurate and appropriate.

Like Fligstein, Jackall sees managers as wishing to avoid uncertainty, and desiring predictably, something which functional rationality can provide. However, Jackall observes that managers often disguise the underlying motivations for decisions with "vocabularies of rationality" especially if the decisions were actually motivated by personal impulses (Jackall 2001, 80). Jackall, writing during a period of deconglomeration, notes decisions by a CEO to engineer a leveraged buyout of the most profitable division of the company because it did not "fit with the strategic profile" of the company. In fact, his informants suggest there was animosity between the CEO and the president of said division. The deal was organized because the CEO wanted to get rid of him but did not have enough power to fire him (Jackall 2010, 81). Jackall notes other cases where assets were sold off for "dumbfoundingly low prices" because of their low profitability. In fact, Jackall notes the low profitability was more a result of a 40-year-old contract that meant the goods produced by the asset were being sold far below market rates (Jackall 2010, 81). Jackall describes the CEO as a prototypical manager of the financial conception of control, "a man with a financial bent and a ready eye for the quick paper deal" but he does not address the tremendous pressure faced by all larges firm to sell off low profitability divisions as a result of the institutional pressures Fligstein identified (Jackall 2010, 81).

What it appears Jackall doesn't realize is that the corporate world that he was studying was in the middle of a radical change. He notes "a shared sense of beleaguerment" experienced by the managers in every company he observes, a feeling that they "and their traditional prerogatives.... [are] under siege" (Jackall 2010, 156). In fact, as I will explore more in the following chapter, the managers were under siege by economic theorists who blamed them for economic recession. However he links it to a more general critique of business and business ethics that challenged "historical claims of legitimacy" and a growing belief in "a variety of perceived social ills said to be attributable to business" (Jackall 2010, 157). However, in light of

the reorganization of the US corporate form that was occurring, and the blame being assigned to managers, it appears this could be the primary source of their beguilement. His insight is that this critique questioned the contributions of business to social progress and seems to foreshadow how shareholder value, the conception that was emerging, came to address the social value of business activity.

Often it appears that what Jackall sees as the somewhat arbitrary goals issued by senior management, for example CEO's who demand no increases in spending to project or convey an "asset reducing attitude to Wall-Street" or who desire to promote "lean hungry and aggressive management," are in fact reflections of the conception of control (Jackall 2010, 93, 64). In a very cynical take, Jackall contends that CEO's are actually motivated only by helping themselves and their allies, but have so internalized the double think they feel justified in doing so. Thus the values that guide the CEO and upper managements directives to subordinates are dictated by the conception of control, which allows them to apply functional rationality to strategic decisions and leave the substantive details to lower level employees. Jackall, perhaps unsurprisingly, finds that "hard work does not lead to success in the modern corporation." His claim that this stems from the fact that there is "no fixed or objective standard of excellence" looks at the financial conception of control, and its measure of efficiency, as dictating the standards by which the corporation as a whole will be measured (Jackall 2010, 217).

Jackall's work reveals some interesting details about how the financial conception of control works in practice and consequently highlights the value of keeping institutional theory in mind. He notes that "the training of professional management increasingly focuses in on the main techniques of financial wizardry..leveraged buyouts, arbitrage, stock protection.. and on quantitative measures of organizational performance" (Jackall 2010, 87). Jackall discusses this in context of what he says is an increasing tendency for managers to focus on the short term. By

mastering these conceptual tools, managers can be “on the defensible high ground of rationality in explaining choices in public forums” (Jackal 2010, 87). When remembering Fligstein's discussion of the financial conception of control, as occurring much before Jackall's ethnographic work, we see how being on defensible ground is the appeal for any given conception on control. What makes financial tools appealing compared to other conceptions of control is their flexibility and generalizability. They allow managers to justify a variety of decisions using the same discourse, which simplifies their job through the application of functional rationality to complex problems. Jackall is alarmed that “management training today gives little or no time to production management” given that “production is precisely the nexus of the whole economic process” (Jackall 2010, 87). Fligstein suggests this process began in the 1960’s and was almost complete by the time Jackall studied the corporation.

Substantive rationality is used to both assess the goals of the organization, and which individual goals will result in advancement and avoidance of blame. The conception of control allows the distinction between individual goals and organizational ones to be disguised, and the reproduction of the corporate ethos.

Chapter 2-Shareholder Value and the Securitization Machine

Economic agency and the neoliberal economic policies discourse allowed the seemingly short sighted and greedy perspective of shareholder value to been seen as morally acceptable because of the efficiency of the market and thus the idea of shareholder value has come to dominate the literature of organizational theorist and management science, as well business and finance. Robert Jackall's *Moral Mazes* highlights how managers can manipulate the financial tools that are the basis of shareholder value to achieve short-term success and then use the social capital generated by success to avoid responsibility for the consequences of the inevitable failure. The limits of these tools are obvious to managers but understanding how the actors who investment bankers reward these use of these strategies is essential to understand the direction of economic growth in the 21st century.

Several authors have studied finance in 21st century and it from them we can build on Jackall's understanding of corporation and attempt to understand how the formal rationality, provisional language and organized irresponsibility, and the corporate ethos. To do this, we first need to review the growth structured finance products known Asset Backed Securities, and Collateralized Debt Obligations, and derivative product known as Credit Default Swap. These products were produced in the 1980's but were an essential element of the Credit Crunch.

Economic sociologist, Ezra Zuckerman, in attempting to understand dediversification from an institutional perspective, highlights the role of specific practices of banks industry in organizational change to understand the social construction of 'shareholder value' and its positive applications. In this model, the role of analysts, by which Zuckerman means the risk and securities analysts within investment banking firms, is dominant. He notes that "managers are

dependent on investors—and more directly, analysts--- for a high valuation of their firm" (Zuckerman 2000, 217) As a result, analysts conceptions of what a corporation should be and look like have tremendous power, which he argues is inspired by the desire to reduce firms profile to match stock market industry codes (Zuckerman 2000, 615-619). He finds evidence that the evaluative frameworks used by analysts, specifically industry codes are useful in predicting how much a firm will implement shareholder value rationale and will pressured to confirm to investors demands (Zuckerman 2000) While this is only one aspect of the shift in corporate form, his analysis highlights the of banks in creation of shareholder value.

The 1980's Savings and Loan Crisis and the Creation of the Securitization Machine

As Bill Gross observed, the 1980's also saw the emergence of new forms of financial innovation, called securitization, derivatives, and portfolio insurance. These products were part of larger growth of financial innovation that used computer models such as Black-Scholes equation to attempt to remove risk from investing. This was done by engaging in the practice of hedging, or using a mixture of short (designed to make money when prices fall) and long (designed to make money when prices rise) positions to remove risk from investing. In October of 1987, stock prices collapsed, and though it is still contested, many of these portfolio insurance programs, which were created to reduce risk, actually resulted in greater losses during the crash (Jackall 2010, 223). Despite the market crash during the Savings and Loan Crisis, the shareholder value ideology survived.

During the S &L crisis small local banks known as Savings and Loans began to go bankrupt at an alarming rate and required a government bailout. Savings and Loans are named as such because their business model was to take the savings of the local community and reinvestment them back into the community through loans, chiefly commercial and residential

mortgages. Traditionally, the savings and loans would hold on to the mortgage note (the promise to pay off the mortgage) until it was repaid. However legal changes enacted under deregulation enabled them to engage in loans not dependent on their local geography, and engage in the trading of securities (Jackall 2010, 223).

Briefly described in the introduction, a process called securitization gave banks the ability to create a new type of security, a mortgage backed security (MBS). Mortgage backed securities, and securitization were invented by the US government in the 1970s in an effort to make housing sector grow faster. MBS created a way for home lenders to sell the mortgage notes in bundles that resembled bonds (loans to corporations). The government sponsored entities (GSE) Fannie Mae, Freddie Mac, and Ginnie Mae, used securitization to increase the number of loans they could make since if a loan was securitized, it could be sold off, freeing up more capital to make more loans (Fligstein 2010, 12).

These government-backed mortgages issued by the GSE were different from bonds however. They enabled the borrower to prepay the loan without penalty. While banks had some experience pricing the risk that loan would default, they did not have experience with loans that could be prepaid. This was a risk because it would decrease the profit made from the loan. To incentivize banks to buy them, the GSEs backed the loans. They would compensate banks from the money lost in default or prepayment (Mackenzie 2011, 1790).

The mortgage market was initially small. Because the product was new and there was no procedure to evaluate mortgages or understand the risk, not many banks purchased MBS. However, in cooperation with investment banks, the government introduced a system called tranching. Tranching divided the security up into sections with different risk and a rate of return that was proportional to risk (Fligstein 2010, 12). This increased the number of investors willing to purchase these products. But the market still remained relatively small (Fligstein 2010, 12)

In 1977, the first private label (not government sponsored) securitization was created (Mackenzie 2011, 1792). By 1985, private label securitizations were used to bundle and sell a wide variety of loans including commercial real estate, credit card debit, and auto loans (Mackenzie 2011, 1793). The process of creating these products is what is referred to as the securitization machine.

The securitization machine worked by packaging together the individual loans into separate legal entities called a special purposes vehicle; essentially a corporation created by the underwriter (the government, or in the case of private label, a bank). By placing the mortgages into this vehicle, it transformations the individual notes into "an asset that pays a fixed rate of return" (Fligstein 2010, 11). The separate tranches are assessed by private rating agencies who assign the level of risk of a given tranche. How the securitization machine is run is a complicated technical process that is well suited to the application of formal rationality, which I will explore later in this chapter.

Additionally, the Savings and Loans, as a result of legal changes in the 1980's and the growth of securitization, were able to sell their mortgage holdings to larger banks to provide the fuel for the securitization machine. Because the procedures for valuing them were still new, they were often sold at a great loss relative to what they would have yielded had the S&L held on to them for the duration (Jackall 2010, 223, Fligstein 2010, 14). By some accounts, Savings and Loans did this to raise capital and increase profits in order to stay competitive in the face of deregulation (Fligstein 2010, 15). This explanation, though, is in line with what would be expected of the manager of corporate bureaucracy and may not actually be what is going on.

However, SEC regulator William Black, the proponent of the control fraud theory discussed in the introduction, suggests it was done only for the sake of executives profiting (Black 2005). Fligstein summarizes a similar dynamic. Mortgages were sold off into MBS by

investment banks, "primarily Solomon Brothers" and the banks then began to offer high interest saving accounts. At the same time, they begin to make "very risky investments", what Black probably claim were fraudulent investments. This resulted in the real estate bubble, which popped in the crash in 1987, taking many S&L and their stockholders with them (Fligstein 2010 15).

Although such a crisis could have been the end of shareholder value, Fligstein notes that the crash of savings and loans "was a fortuitous event" for those involved in securitization because they longer had to compete with S&L's, and it greatly expanded the mortgage backed security market (Fligstein 2010, 16). The GSE's "took up the slack from the savings and loans banks...by 1990, less than 15% of mortgages were help by savings and loans" (Fligstein 2010, 16). Fligstein understands the growth and response of the financial sector in response to this crisis as a simple increase in aggression that led to a "financial revolution." In light of the corporate ethos, it appears banks found a way to blame others and socialize the losses, so shareholder value was not really threatened. Before examining this however, it is useful to finish exploring the structural features of this financial growth.

The Aftermath of the S&L Crisis: Lessons Learn or Formal Rationality Refined?

Karen Ho conducted an ethnography of investment banks during the 1990's and early 2000's, and produced remarkable evidence to explore how banks, as corporate bureaucracy under shareholder value, train their employees to think and act. The ethnography, *Liquidated* was conducted in the period of time immediately preceding the Credit Crunch when the securitization machine was growing full swing. She found the bankers defined themselves and their industries' goals of creating shareholder value through their perceptions of the 1980's (Ho 2009). Referred

to as the "Deal Decade," the 1980's are remembered for the junk bond traders immortalized by the fictional insider trader Gorden Gekko and his motto "Greed is good", as well as Michael Lewis's nonfiction account *Liars Poker* (Ho 2009, 132).

Unlike the managers Jackall studied, it appears that ideologies and mythologies, and understanding of its language have moved beyond the internal publications of the corporate bureaucracy. The bankers Ho studied come into the industry already having internalized the justifications and provisional language, through the various "memoirs, movies, exposes, journalistic reports and thrillers" written about the takeover movement (Ho 2009, 132).

Consistent with my synthesis of Jackall and Fligstein, she finds that the bankers must internalize the values and beliefs of the corporate bureaucracy in order to justify past actions as consistent with narrative of shareholder value control and its view of economic efficiency. Ho notes their explanation of the 1980's is "remarkably coherent" and based on the "rightness and inevitability of the strategies adopted by corporate raiders [and] junk-bond traders" (Ho, 2009, 132). Echoing the claims of the agency theory that supports shareholder value, Ho's informants describe conglomeration as an example of "managerial self-interest and waste" which justified the takeover movement and the shareholder value conception of control (Ho 2009, 133).

The logic, which appears strikingly similar to that used to support sub-prime securitization business, was that they could obtain huge fees without putting their own money at risk (Ho 2009, 137). Additionally, she finds evidence of Wall-Street applying formal rationality although at first it appears as substantive rationality "by re-framing its goals and financial products" (Ho 2009, 138). Consistent with the corporate ethos, a superficial change of the status quo was not done until absolutely necessary because of a crisis, the 1987 stock market crash, which "necessitated reinvention" (Ho 2009, 138). Substantive rationality was applied in order to produce new language to "remarket" the same tactics of the 1980s in a "social acceptable way"

(Ho 2009, 138). Ho describes this as a shift in the rhetoric of shareholder value, which her informants were not willing to accept as a failure of shareholder value or its tactics. Some came close, such as an informant from JP Morgan, who when confronted with the seeming inconsistency of shareholder value with social good, replied "We can wing it like that. For me, its all about getting the share price up". The market is looking for a rationale, and banks provide them with one they will find plausible, even if they do not believe themselves (Ho 2009, 161). Ho sees this as an acknowledgment that efficiency is understood to be a social construction, or at least "a marketing strategy" (Ho 2009). This reflects the degree to which bankers have internalized the logic and values of shareholder value, independent of its actual effectiveness. Another informant used the goal of increasing shareholder value as justification for "playing the game.. meeting analysts expectations...managing your balance sheet so you look good at the end of the quarter" (Ho 2009, 161-162). Ho uses this interaction as evidence that increasing share price is "enough of a goal." In light of the corporate ethos, this talk of getting the share price up is a formal rationality where the goal cannot be questioned, resulting in internalization of the value.

Summarizing her informant's defense of shareholder value through efficiency, she finds it "contradictory and inconsistent (Ho 2009, 162). Additionally, shareholder value itself seems an incomplete justification for financial practices, which she attributes to the failure of neoclassical economic thought and its notion of efficiency.

For her informants in investment banking "efficiency referred to the set of practice which most quickly and cheaply translates corporate actions into rising stock prices" while at the same time acknowledging that many of their firms practices were not efficient by standard metrics (Ho 2009, 163). She does not see this as a case of provisional language where efficiency is used to refer to whatever actions the bank engaged in which increased shareholder value, disguising

formal rationality as substantive. Instead she calls on academics to recognize that "not only has the definition of efficiency changed, but also that efficiency is simply not being produced" because "investment bankers often times do not create shareholder value" (Ho 2009, 164). That her informants, mostly middle level to lower level employees, "did not fully question the mission of shareholder value" is not surprising, as they are in the process of internalizing it and not in the position to question it (Ho 2009, 164). Like all corporate actors, we would not expect them to apply substantive rationality to assess the conception of control and its goals on behalf of the corporation.

In contrast, she finds more seasoned bankers have a "subtle critique" in regard to its short-term focus. But, as expected by individuals who have internalized the corporate ethos and shareholder value as consistent, they do not reject it. They defend shareholder value on the logic of agency theory, but also acknowledge the limitations of agency theory. They do not see a plausible way to use incentives, as agency theory attempts to do, to align the long term interests management and shareholders (Ho 2009, 166). Indeed she finds evidence that linking compensation to share price is understood to produce a short-term focus. This focus is something that Jackall showed supporting corporate ethos by allowing individuals to outrun their mistakes and engaging in milking. Interestingly, it is a senior manager at Lehman, who appears to not have internalized the ethos, by acknowledging to her that there is a "discrepancy 'between what Wall Street *pretends* the objectives ought to be, and what they actually are" (Ho 2009, 166, emphasis hers). In the next chapter, I will explore the distinctions between firms that survived the crisis and those that did not; Lehman is in the latter group. It could be that more seasoned bankers are more aware of the conflict between shareholder value and reality, and she notes it was junior employees who were quick to rationalize shareholder. It could also be that executives from Lehman she quoted had not mastered the provisional language or internalized its values.

Ho's understanding of shareholder value, though, was less complete than that described in Fligstein's book. The inconsistent use of shareholder value by her informants left her "confused" and believing that rationalizations came "across as self-serving" (Ho 2009, 167). This left her struggling to explain how her informants could engage in deals that would decrease stock price for clients, and yet continue "to use shareholder value as justification" (Ho 2009, 167). Her initial findings, that shareholder value was Wall-Street's "moral blueprint…could not fully explain how investment bankers were prone to seemingly contradict their own value system." This led her to focus on the everyday practices of Wall-Street, its specific institutional culture, and generalized "financially oriented corporate culture" (Ho 2009, 168). Consistent with notion of shareholder value as conception of control, and corporate ethos, she finds shareholder value has no fixed meaning, and can be used to justify a multitude of actions. Its meaning is dependent both on "power relations…[and] particular cultural and institutional context" (Ho 2009, 168). Thus the shareholder value conception of control is incredibly useful as a conception of control because of its flexibility and ability to obscure conflict of interest.

She finds that a "specific corporate culture of investment banking creates a model for banker action" and that this culture is "designed to be in lockstep with their ideals of the market" (Ho 2009, 293). This model, and Ho's finding in general, seem remarkably consistent with understanding that shareholder value is a conception of control, a cognitive framework used to hide a value framework that is the corporate ethos. It insures that the application of formal rationality and substantive does not endanger the status quo.

The shifts and crisis in the 1980's helped define and refine shareholder value. They highlighted how adaptable it was to the needs the corporate ethos in financial firms. The Savings and Loan Crisis especially helped refine the discourse of shareholder value, and establish a

historical narrative to justify Wall-Street's dominance and an increase in financial innovation. It also helped refine the formal rationality of the securitization machine.

The Securitization Machine as Formal Rationality, and its Role in the Credit Crunch

During the Credit Crunch, the single biggest category of loss ($290 Bill) was hybrid securitized product known as an ABS CDO (Asset Backed Security Collaterized Debt Obligations). These losses were concentrated at "the very core of the global financial system" (Mackenzie 2011, 1779). Donald Mackenzie attempted to understand how the banks that created and ran the securitization machine, and designed the models to evaluate CDO's risks were almost destroyed by these securitized products. He frames the crisis as a problem of organizational knowledge and supports this with extensive interview data (Mackenzie 2011). However he does not explore how the bureaucratic corporation, via internalization of its values and the language of shareholder value, colors his subjects understanding of the crisis.

Collateralized Debt Obligations (CDO) "were originally a simple extension of the techniques employed in the 'private' label securitization" (Mackenzie 2011, 1800). Like Asset Backed Securities (ABS) they were designed to help spread risk and free up capital for more loans. Both are created by combining a pool of contracts into separate legal entities, and then dividing the pool into different groups, called tranches. These tranches are hierarchical, whereby the highest tranches (the super senior) are the safest and have "the first claim on the income from the pool of assets" (Mackenzie 2011, 1807). The lower tranches, senior, mezzanine and equity, are riskier (but still relatively safe) and thus offer higher yield (Mackenzie 2011, 1807) .The stated advantage of these instruments was that it allowed greater funding/increased lending while offsetting the risk or spreading it out so that even if some homeowners or corporations defaulted,

as long as the amount was below stress test levels, the financial product would still perform well. Mackenzie observed that this arrangement created a conflict of interest because the lenders of the original assets (ie mortgage issuers or bond purchaser) did not lose money if the debtor failed to pay so they had no reason to the issue loans to people who would likely pay them back (Mackenzie 2011, 1808). This conflict of interest is the same as the one, which led to collapse of Savings and Loans.

In contrast to ABS, which stemmed from a loan to purchase an asset, CDO's were a way to securitize any type of contract, a loan or bet and in practice different than an ABS. They were originally on the "fringes of finance." But by 1996, they become an essential way for banks to spread risk on products besides mortgage loans (Mackenzie 2011, 1800). In contrast to government backed ABS, there was no prepayment risk for the loans underlying these securities, and the details of securitizations were opaque. The banks hid the names of corporations or investors involved in the underlying assets, unlike MBS, where the individual mortgages were recorded and public (Mackenzie 2011,1801).

Understanding the risk of these products thus is about understanding how many of the underlying contracts we would expect to fail, how correlated the underlying notes were. Essentially, that the failure of one loan or underlying contract might increase the chance of failure related to others in the pool. As noted earlier, evaluating this risk was a new task, and despite the structural similarities between these two products, they had different functions, and were used in a different division of the bank. Therefore, they were evaluated and priced very differently.

From the perspective of sociology of knowledge, evaluation is a knowledge problem, and Mackenzie draws on the work of Carruthers and Stinchcombe (1999) who seek to understand the "canonical mechanism" underlying the evaluation of corporate stock price. (Mackenzie 2010,

1780). These mechanisms are established by those in a position of power and help produce a "standardization of financial claims" based on sharing of a sets of normative methods of evaluation (Mackenzie 2010, 1780). These canonical mechanisms allow a bureaucratic corporation to apply formal rationality, and have the stability and predictably required to maintain the conception of control and obscure the conflict of interest between the interest of the managers and the shareholders. We can think of these types of mechanisms a supported by, a specific conception of control.

Mackenzie presents two scenarios for understanding these practices: a rational choice perspective of "self-interested rational actors freely choosing their actions" and a cultural one whereby actors 'incorporate institutional rules by taking for granted without much decision or reflection... did" (Mackenzie 2011, 1830). Clearly as an economic sociologist he does not side with rational choice scenario, which he equates with the "ammoral calculator hypothesis": actors saw the danger in their practices and ignored them for the sake of money (Mackenzie 2011, 1830). In using culture, he does not want to deny the agency of participants, noting that "reflexive, calculative action" played a major role, but that they used incomplete and ultimately dangerous models because they "were familiar and convenient" and analyzing them with more complete techniques would have simply been too time consuming (Mackenzie 2011, 1831). While familiarity may have played a role, these models were used not only because they were easier than trying to find a new model, but because changing this model would have upset the status quo and put ones career at risk.

What Mackenzie then wishes to focus on explaining is how the canonical mechanisms that eventually emerged to value them were flawed. But, because of the structural and cultural realities, no one truly understood why until is was too late. That his informants and the primary sources he reviewed did not see the danger of ABS CDO's is evidence of the organizational

routines/evaluation practices hypothesis. It is also for the existence of provisional language and a conception of control that masks the corporate ethos. He suggests that the silence on the dangers of many investments before the crisis could be seen as an example of "Bourdieu's 'complictous silence', and thus evidence of 'ammoral calculation.' (Mackenzie 2011, 1832). This notion of complicit silence is similar to theory of a corporate ethos, but ignores that those in a position to speak out do not view the decision as moral one, but rather a choice between self-preservation and job loss. He does not support this theory however. He finds that his data suggest that a more plausible explanation is that firms with better organizational structure, i.e. one that allowed lower analysts to question higher ones, chiefly Goldman Sachs, were able to recognize the dangers voiced by those junior analysts with familiarity with the products (Mackenzie). An analysis of other banks, though, chiefly Morgan Stanley and Merrill Lynch does not this. However given the tendency of executives to create underlying insight, and as I will show shortly, the complexity of the hierarchy in these banks resulting from MLSF, suggests this theory is implausible or at least incomplete.

Finding a way to spread risk, albeit financial risk, is consistent with corporate ethos. CDOs actually enabled banks to, at least on paper, produce "risk-free profit" (Mackenzie 2011, 1801). Originally rating agencies evaluated CDO's procedurally. Eventually, banks produced a new model that allowed correlation, the non-independence of defaults, to model explicitly and mathematically. From then on, CDO's were evaluated very differently, which Mackenzie credits to their emergence from the world of "modern mathematical modeling of financial derivatives" which was an essential part of 1980's Wall Street Boom (Mackenzie 2011, 1811). Banks produced a new model that allowed correlation of defaults, to be modeled explicitly and mathematically, using the Gaussian Copula model. This meant that an estimate of the correlation between companies (or later subprime mortgages) could now be reduced to an input variable,

whose value was proportional to risk of a given CDO tranche. The rating of these products, like the rating of ABS, was an important part of simplifying and standardizing the field (Mackenzie 2010, 1796). This standardization was useful by allowing for the application of functional rationality to the production and evaluation of these products.

Rating agencies evaluated ABSs and CDOs very differently however, as Mackenzie notes in the case of ABSs. An AAA rating meant that the tranche in question would survive Great Depression default rates, the so called stress tests (Mackenzie 2011, 1809). The models that were used to predict this assumed/required that defaults be treated as independent events, that is that the occurrence of one default did not provide any additional information about the likelihood of another default. The rating agencies understood this was a false assumption, but relied on what Mackenzie calls procedural methods to address the correlation between defaults. This meant assuming that the correlation of defaults that occurred in the great depression was sufficient to predict current correlation, and geographic correlation was assessed by penalizing securities by one rating grade (ie AAA to AA) if they were thought to include too many loans from the same area (Mackenzie 2011). Institutional investors often went into even greater detail, analyzing each individual loan/mortgage in the pool. If they found too many risky loans, they demanded the pool be reorganized (Mackenzie 2011). The type of evaluation represents functional rationality, where actors developed universalized rules to ensure they got the ratings their bosses and or clients demanded. There was not a mathematical model based on financial statistics, only a test that worked in the past to see how the loans would perform if subjected to the most severe circumstances in recent memory and kept free from what had been historically unacceptable levels of geographic concentration.

ABS CDOs are structured where the assets underlying the CDO are tranches of an ABS. These products and the "assembly lines" that created them resulted in incentives and structures

('reshaped the market') that supported loose mortgage writing standards. The producers and consumers of these financial products did not understand them in the same way because of cognitive and organizational differences that resulted in different social and material constructions of value (Mackenzie 2011, 1779). In the same way, the credit ratings that facilitated the incomplete view of these products was socially constructed and constrained by, borrowing from agency theory, what Mackenzie calls "path dependent cultural mechanisms" resulting from historical circumstance and structural practices that masked the underlying confusion. This type of confusion is rooted in a problem of value that emerged because these new financial products could no longer be evaluated or understood via "canonical mechanisms" (Mackenzie 2011, 1780). Canonical Mechanisms are essentially systems of functional rationality that allow actors to standardize how they evaluate and produce a product. These mechanisms in turn must be consistent with the conception of control.

The collective confusion that resulted when new mechanisms were produced in the differing "evaluation cultures", of ABS versus CDS, had different structures and roles, and different ways of understanding and calculating value. Mackenzie in part wants to show that this does not indicate an amoral calculation. Mackenzie's hypothesis is supported by excellent interview data that enabled a comprehensive understanding of technical details of the construction and evaluation of the incredibly complex financial products that have accompanied the shareholder value revolution. This deep understanding of the decisions made by these actors gives his hypothesis a detail and nuance, that like Karen Ho's work, seeks to understand larger dynamics by looking at the daily practices and culture of Wall-Street. However when integrating this hypothesis into a larger model of corporate governance/behavior, his model of how agency functions in evaluation underestimates how hierarchy and the corporate ethos complicate understanding. What such a simplified notion of organizational reality underestimates is how

bureaucracy and hierarchy refine and reward an agent's ability to navigate different views of reality. By only seeing the credit crisis as a grand case of what happens when the 'left hand does not know what the right hand is doing' in order to disprove the amoral calculus hypothesis, he is supporting an incomplete notion of the levels/forms on which agency functions in the corporation. He did see that actors had a reason to support (even unintentionally) such organized irresponsibility, and thus both were unable to look at the problems for what they actually were and to fully appreciate their consequences. There is problem of knowledge underlying the credit crisis and it is rooted in differing evaluation cultures. It is not just a structural problem but a reflection of the conflict between the values of the corporate ethos and the stated values of the conception of control, a problem his informants have been trained to rationalize.

That said, there is no doubt that the complexity of these deals generated incredible confusion and played a precipitating role in the crash. It was the collapse of ABS CDO's that resulted in the write-downs that generated billions in losses overnight. Because of the nature of the CDO's, these losses represented 2.5 times the value in the underlying mortgage securities (Mackenzie 2011, 1819). However the people who produced and sold these products were able to exploit two age-old corporate techniques identified by Jackall, milking and out running mistakes. The people who invented ABS CDO's, and credit default swaps, along with those who perfected their use to produce incredible profits, were well rewarded for their efforts. Mackenzie's insight to the functional rationality of ABS CDO constructors ignores the evidence that has emerged after the crisis that many involved understood how their practices were misleading and fraudulent (Mollenkamp 2012). He does identify hierarchical pressure as a source of confusion, noting that his informants had "a mandate to do the CDO.. to get it done...to buy something" (1812 double check). They used functional rationality to find new ways to value CDO's because that was what they thought was in their best interest and what their bosses

demanded. To see it only as a problem of knowledge ignores that in addition to simply relying on imperfect models with faulty estimates of credit correlation, many of them also fudged the numbers and understood the risk they were taking and continued on because such practices are the status quo in major corporations

The key point is that the cultures/worlds of ABS and CDO's were "cognitively quite different and organizationally largely separate." Thus ABS CDO's became "a kind of epistemic orphan" (Mackenzie 1779). These products indeed became an orphan but only after they fell apart, as actors worked to avoid blame and out run mistakes, but before exploring why they were orphaned

Using mathematical modeling would appear to be an example of substantive rationality taking the place of functional, however Mackenzie shows the mathematical models initially produced ratings/risk assessments that were remarkably similar to the procedural, implicit models (Mackenzie 2011, 1812). Mackenzie quotes one rating agencies analysts that correlation values was chosen "partly to maintain consistency with the previous notching scheme" and thus generated similar results to what the procedural, judgment based, functionally rational approach had produced (Mackenzie 2011, 1806). This shift is consistent with remarking of investment banking observed by Karen Ho. This shift also allowed ABS CDO's to be rated as if they were not doubly tranched, and is what Mackenzie calls "eating their lunch twice", which had important implications for taking down banks during the crash, missing this dynamic is what Macenzie claims can explain why banks engaged in trades that ended up losing billions (Mackenzie 2011 1809).

In Mackenzie's model, evaluation practices are somewhat deterministic, that is, they "are the path-dependent outcomes of historical contingencies" (Mackenzie 2011, 1783). Path-dependency is corrective from developmental economics to neoclassical economics that

attempts to model the role of historical events, institutions, and culture, on market outcomes (Nunn 2009). This concept can explain institutional inertia and is certainly better than an ahistorical analysis but it suggests an agency simply based on actors making the easiest possible choice, instead of producing complex webs to hide blame and responsibility, consistent with the corporate ethos. Mackenzie demonstrates how the focus on prepayment risk came to dominate evaluation practices because the government backing of the 'American Mortgage' which appears to be very important in understanding the evaluation practices of the rating agencies. However when he summarizes the value of path dependency via historical contingency as allowing us to see that "it easier, for example, to modify an existing practice than to develop on entirely one" he ignores how and why actors in a bureaucratic hierarchy can change practices (Mackenzie 2011, 1783-84). Path-dependency as used by him, seems to reflect conceptions of control, whereby solutions to problems of governance based on changing structural and institutional realities, constrain evaluation practices because they would conflict with already existing structures. This is the type of thinking that underpins functional rationality, but path dependency can also be seen as result of corporate ethos, where functional rationality dominates substantive. Thus producing new solutions to control without offending superiors, in the case of making models that confirm the existing ratings and practices, means finding new means, and language, is done to obscure that the underlying motivations for the practice have not changed.

Conceptions of control, which in Fligstein's model emerge from upper management during crisis, map on to Mackenzie's model of canonical mechanism shift in the 1980's. Mackenzie exposes that during times of transition, or when canonical mechanisms have not been perfected, or brought in line with the practices of the prevailing evaluation practices, arbitrage opportunities can exist, as was the case in the 1980's. These differing conceptions of control in Mackenzie's framework are the distinctive ontologies "presuppositions about the nature and

properties of the features and processes of the economic world" (Mackenzie 2011, 1783). Seeing ontologies as part of conceptions of control, that is as (divisions or industries or firms) specific solutions to problem of implementing managements vague directions, it seems the specific content of the ontologies can be understood simply by understanding the history of the evaluation of the assets in question.

This is a forgone conclusion if we recall the insight of Jackall, that power in the corporation is exercised by the performance of routines dictated by management. Despite the potential advantage of evaluating similar product in a similar way, this would reduce the power/social capital of the leaders of the divisions, even if it would be the best way to produce shareholder value. This is form of organization is substantive rationality guided by the value system of the corporate ethos.

Mackenzie does acknowledge that evaluation practices connect to corporate governance and thus their appeal/usefulness to management. Because evaluation practices regulate action, they "become means of governance via the process of credit rating" (Mackenzie 2011, 1784). Credit ratings practices do represent an important part of shareholder value control, as his fifth postulate notes, they reduce "difficult problems of evaluation" resulting from the complexity of financial products by providing a tool to compare investments without knowledge of their details" (Mackenzie 2011, 1784). The ability to compare investments without familiarity with their details is one of the chief advantages of financial control and Mackenzie notes that many traders of CDO's, let alone their bosses, did not understand the Gaussian copula models that were used to produce ratings of CDOs (Mackenzie 2011, 1785). Complex financial products could then be understood simply by their rating and the spread offered, and at some point (Mackenzie is not clear when) the products were constructed only to produce the desired rating and spread, not based on analysis of risk or understanding of the details. However the evaluation practice is

only one part of corporate governance and as Jackall showed formal evaluation practices were often just a formality that was easily manipulated. This lack of understanding may perhaps more cynically be understood as acceptance of practices that were able to be manipulated, thus supported the corporate ethos. This seems to follow from the fact that differing forms of evaluation “on the same instrument, or same risk” allow for 'risk-free' arbitrage profit. For Mackenzie this is the real motivation for most of creation of ABS CDO's that led to insatiable demand for subprime mortgages (Mackenzie 2011, 1786-1788). He assumes that most users of these evaluation practices had faith in the ratings they produced, instead of realizing that faith in them was required to do their job without experiencing cognitive dissonance. They had been well trained to use provisional language to make functional rationality appear like substantive in pursuit of shareholder value and to obscure their own desire to simply outrun mistakes.

Chapter 3 -The Corporate Ethos and the Credit Crisis

The critique of Mackenzie theory in last chapter, and my theory about the role of bureaucratic control in the financial can be substantiated and fleshed out by exploring how the dynamics the corporate ethos, its provisional language and internalized of the lack of conflict between the organization and the individual, played out in the crisis. The securitization machine was milked, and when it exploded the same types of CYA techniques were used.

A recent piece by former Wall Street Journal writer Carrick Mollenkamp for ProPublica shows that the milking of the securitization machine often depends on illegal practices. The analysts tasked with producing the data for the Gaussian copula models were asked to alter the spreadsheets in order to secure the proper rating (Mollenkamp 2012). Concerns about this practice were only raised when it was outsourced to Mumbai. An analyst, perhaps unfamiliar with how normal such practices were, or hoping to make a superior who did not like him look bad (two common motives according to Jackall) filed, an internal complaint. (Mollenkamp 2012). Mackenzie's hypothesis is based on the idea that credit crisis occurred because 'gatekeepers' , institutional investors and the rating agencies, no longer had the incentive to properly rate ABS's. Mackenzie's information only capture part of the story. He uses the case of banks who purchased sub-prime backed ABS CDO's who were not simply purchasing their own senior tranches out of necessity but purchasing other firms' ABS CDO's as evidence of a widespread belief that they were as valuable as their ratings indicated. The example he explores in detail is a trade by a proprietary trading group, Morgan Stanley, who managed to bet on both sides of the subprime mortgage market (while claiming to be only betting against it) and resulted in the largest loss in Wall Street history (Mackenzie 2011, 1827-1829). The outcome of this trade, much like the explosion of a 'milked' chemical plant in *Moral Mazes* was inevitable. But

Mackenzie wants us to believe the traders believed in the ratings because they had not been involved in constructing them. Those in charge of producing the ratings certainly did accept the ratings at face value but even if they did uncover they were flawed, and thus a danger to their firm or the economy at large, they were not willing to risk loosing their job. He highlights several trades that occurred just before the crisis, when the failures of the model would seemingly be well known between Morgan Stanley, Merrill Lynch, and a Japanese bank, all banks where the employees still believed in the value ABS CDO's (Mackenzie 2011, 1827-1829).

However, more research from ProPublica into Merrill Lynch's CDO division shows that those who purchased ABS CDO's understood their risk to firm was not reflected in the numbers and were rewarded for accepting the losses (Berstein and Eisenger 2010). Much like in a corporation, where the employees willing to take the fall for their boss are rewarded, ABS CDO's were understood to be a short term fix that everyone was trying to outrun. Given that as Mackenzie notes, firms pursuing the same strategy coordinated their action via long established interbank collusion, it is not surprising that firms would understand the risk but be unable to behave as if they did. This would undermine the corporate ethos and the shareholder value conception of control. The Merrill Lynch case shows another example of how insiders knew the danger of these funds but were simply hoping to outrun their mistakes and leave someone else with the blame.

In the middle of 2006, Merrill Lynch was unable to sell the super-senior trenches of its ABS CDO's, many of which were being created in order for hedge funds (often run by former employees) to bet against them (Berstein and Eisenger 2010). Super-senior trenches had always been a problem for the securitization machine. They were hard to sell because despite their low risk, they yielded very little, and were increasingly purchased by the bank that issued them

(Mackenzie 2011, 1810-1813). Fligstein writing in 2010 also uses the example of banks holding on to super senior tranches as evidence they understood the risks involved. However in the beginning of 2006, one of the major purchasers of these CDO's, AIG, stopped its purchases. But, as Merrill continued to produce them, it had to find a buyer. Many of its own traders also understood the risk involved in these products and by the middle of 2006, refused to buy them at all (Berstein and Eisenger 2010). However stopping their production would mean someone would have to look bad and admit a mistake, something that is never done until there is no other choice. Instead, by applying substantive rationality consistent with the interests of employees, and thus corporate ethos, the firm came up with a solution: they forced less powerful traders to buy them or else they would loose their job (Berstein and Eisenger 2010). Those with enough social capital to refuse to buy them remained, but others were punished for their dissent. One a Merrill trader who " refused to buy the super-senior, believing that he should not be buying what no one else wanted.... was sidelined and eventually fired." (Berstein and Eisenger 2010). Clearly all the signs were there but no one was able to stop the machine lest they offend all those who are advanced using similar practices and lose their job.

Merrill created a special group composed of lower level management and junior analysts to purchase the super-senior tranches (Berstein and Eisenger 2010).). The group, led by a trader who had spent his career in Asia and three other low level employees, "didn't have the stature within the firm to refuse a purchase, and, more troubling, had little expertise in evaluating CDOs" (Berstein and Eisenger 2010). Despite this, the head of the group still wrote a memo to senior management about the exact problems in models that produced overvalued CDO identified by Mackenzie. They greatly underestimated the "systemic risk" involved by not accounting for enough correlation (Berstein and Eisenger 2010). His team agreed and said there was no way to justify continuing to purchase more CDO's. He reminded them though "that it was

good for one's career to try to get along with people at Merrill" (Berstein and Eisenger 2010). Substantive rationality on behalf on one's career, produced this solution, and those responsible for carrying it operated with the end of impressing their bosses and climbing up the corporate ladder. They applied the formal rationality model designed to produce and protect shareholder value to self-serving ends. Because this helped conceal the conflict of interest, they were well rewarded for it.

The CDO group that produced these subprime backed ABS CDO's purchased by the new group shared their bonuses with them, a practice termed "a million for a billion" where every billion in CDO debt taken on resulted in an extra million in bonus pay, which according to who you ask, was either a "subsidy...or bribery" (Berstein and Eisenger 2010). What is interesting here is that the head of fixed income, the person who oversaw both groups, and was in position to take credit for success and avoid blame when its fraud was exposed, was the one who was publicly blamed. He could not it seems, lay the blame on the head of CDO sales group that 'bribed' the CDO purchase group, and he was the one who was fired (Berstein and Eisenger 2010).). The two heads of the CDO group both left Merrill, in late 2007 and early 2008, respectively, one leading his own boutique investment and advising firm and the other a senior manager at PIMCO (Derivatives Week May 4, 2009). This seems to be evidence that the MLSF, which allows subunits of the bank to operate with a degree of autonomy, has altered some of the dynamics of the hierarchy that complicate understanding the corporate ethos.

Something clearly different is happening on Wall Street, where senior traders and department heads can leave senior management out to dry and be rewarded for it. Admittedly all of those involved at the senior level at Merrill, including the CDO's group boss, are now working for smaller firms but in senior roles. The head of fixed income, who was fired for allowing such risk taking, is now managing a private equity fund focused on a new type of financial product,

the first of its kind to be offered, high yield, high risk commercial real estate lending in Europe that banks wish to get off their balance sheets. It seems plausible that one can now outrun their mistakes by going to a new firm, assuming they have not violated the corporate ethos and are thus still seen as valuable for their ability to escape blame while attempting to create shareholder value.

Reflections On the "Worst Trade Ever Made"

It is important to explore in greater detail the case of Howie Hubler and the massive loss Morgan Stanley took when he bet against both sides of the sub-prime mortgage. He bought a large amount of CDS and synthetic CDO's in order to short the market. In order to hedge, he invested in an ABS CDO whose underlying assets were the same types of mortgages he was betting against. This trade was used by Mackenzie and others to frame the crisis as a problem of knowledge. However we should note that Hubler's boss, Tony Tufariello, was not fired and continues to work in the finance industry and that only CEO John Mack took any blame for the actions. By cross referencing author Michael Lewis's and a New York Magazine account about Tufariello's boss, MS president Zoe Cruz, with Mackenzie's understanding, a much more complicated picture emerges. This incident suggests that while miscommunication and misunderstanding about ABS CDO's and CDS may occurred, it also a resulted from substantive rationality guided by the values of the corporate ethos, "cover your ass" behavior of avoiding decision making and implicating others. Without access to more specific details of this incident, it is unclear who knew what when, and how blame was construed. Later in the this chapter I will explore incidents where internal communication has been released, but this does expose how those studying the crisis must be mindful to confusion created by corporate bureaucracies.

Mackenzie and Lewis see this incident as a result of misunderstanding and miscommunication but as shown in chapter one, in the face of impending catastrophe, the substantive rationality of managers will find ways to avoid decision making, feign ignorance and confusion, and involve as many people as possible and set up a scape goat. According to Michael Lewis, Tufariello "was so conflicted that he built himself an office inside Howie's group" (Lewis 2009, 205). The conflict, according to Lewis, was that he was managing both market makers, i.e. those who buy, sell and produce products to create liquidity using clients' money, (in this they case the producers and seller of ABS CDOs) and Hubler who was a proprietary trader. He was using firms own money to produce a profit for shareholders. If Hubler and the market makers collaborated, it would be an illegal conflict of interest (Lewis 2009, 205). Reflecting the discussion by Zey about the role of the MLSF in facilitating fraud for actors placed in positions between networks, Turfariello was thus in the position to detect or support the illegal collusion of these units. In a foot note Lewis calls this conflict "the most pernicious and least discussed conflict of interest" in banking (Lewis 2009 , 205). It is supposed to be prevented by creating an internal barrier for the flow of information known as a Chinese wall, akin to the structural holes described by Zey. Lewis says this structure understood by those in finance as false pretense, or as one analyst puts it, if someone says they have a Chinese Wall in place, it is understood as provisional language only meant for clients, and if someone uses it to justify something internally, the appropriate response is "you're a fucking liar" (Lewis 2009, 205). We must remember however that externally questioning this structure, or internally in writing, is not action that is consistent with corporate ethics because it would undermine the use formal rationality of many profitable operations that depend on the coordination of the activities. Even though analysts understand such a separation to be impossible (this is consistent with the internal flow information in a firm described by Jackall, even with changes resulting from the MLSF),

they must support formal rationality that requires they use models that assume the wall works, lest they expose a greater conflict of interests between their actions and the shareholders interests.

The formal rationally of trading required hedging, meaning that Hubler needed to offset his bet that the subprime mortgage market would crash with a bet that it would not. As Lewis and Mackenzie, agree (albeit with slight differences in rationale) that the $16 Billion purchase of Super Senior ABS CDO was the only way Hubler could make his bet while conforming to the requirements of the value at risk metric. This metric was how Hubler, and by extension Tufariello, would be evaluated, and even if (since we cannot be certain) both understood that it was not accurate assessment of risk, questioning it could make a lot of people look bad. This metric produced the belief that the investment was riskless, enabling Hubler and Tufariello to hit the numbers that were demanded of them. Selling off the hedge, even for much smaller loss then it would ultimately take, would undermine the defense Hubler and Tufariello were seemingly preparing. The deeper conflict that Tufariello was facing was how to mitigate the impending damage of Hubler's now profitable but inevitably destructive trade, and how to protect himself, not the firm, from its explosion, and to ensure someone else was blamed.

Hubler had the chance to sell 6 billion of the hedge in one swoop (and other points attempted to sell more of it). This chance in April 2007, is extremely contested, chiefly the question of how much Tufariello, Hubler, and their boss, president of MS Zoe Cruz, understood the risk of the trade. According to Lewis, Howie attempted to sell 6 billion of the riskiest CDO's to Bear Sterns, and he conferred with Zoe, who did not understand the trade but was worried about the legal risk of trading with now bankrupt Bear Sterns, as well as if the value at risk metric was accurate (Lewis 2009, 210-212). Lewis notes that this incident appears to be divided into two camps, supporters of Zoe, who say Hubler misled her about the risk, and supporters of

Hubler (and by extension Tufariello) who "claim that Cruz seized effective control of Hubler's trade and prevented him from ditching some large chuck of the triple A CDOs". (Lewis 2009, 210). The traders Lewis spoke with, along with his own sense of how financial firms operate, suggest that scenario described by Hubler as highly unlikely (Lewis 2009, 210-211). He describes an ethos in traders that seems to be the direct successor type of thinking observed by Jackall in corporate managers. Although unlike those managers, it seems unlikely the traders might privately hold different beliefs, reflecting the increased internalization seen by Ho as a result of shareholder value. He finds that traders have a tendency to "see themselves in their success and their management in their failure" and that this narcissism or perhaps greed of bankers also explains why they "disdained the need for government regulations during good times [and] insisted on being rescued by government in bad times... Success was individual achievement, failure was a social problem" (Lewis 2009, 210-211). This seems to be clear evidence that the actions of Hubler and Tufariello were guided by the values of the corporate ethos, but with even greater internalization of shareholders correctness and a concern about the conflicts of interest that motivated their actions.

As time went on, Lewis contended that Tom Daula, MS chief risk officer, ordered a stress test for 10 percent default rates, a scenario which would expose the real risk of Hubler and Tufariello's risk free profits (Lewis, 2010, 211). However, according to an article in NY Mag entitled *Only the Men Survive,* Daula was actually acting at the direct orders of Zoe Cruz:

> Daula called to say he'd concluded they could lose Morgan Stanley $3.5 billion, but he still considered that an unlikely scenario. According to a person briefed on her story, Cruz told both Daula and Shear, "I don't care what your view of probability is. Cut the position." The risk was too great, even for her. (Hogan 2008)

Yet according to Lewis, Daula only found MS could lose 2.7 billion, and was very concerned about the trade. Hubler unsuccessfully tried to persuade him that 10 percent default rates could not happen. Lewis also suggests that the risk management department did not believe Hubler understood his trades and was very concerned about the trades (Lewis 2010, 211-212). This stands in direct contrast to story quoted above, which also acknowledges that tellers of the two different stories are divided into two camps with risk management supporting Hubler. Of course Hubler's trade was only one of many that would soon implode, and make risk management officers look very bad, so it would be surprising if they would put the interests of the firm above themselves and exposed how it was not creating shareholder value.

Hogan notes a quote from a former Goldman employee (who was working at MS at the time) that not only refutes Lewis's (and Daulas to Lewis) claims but also Mackenzie's hypothesis that firms with less hierarchical control (ie Goldman and Deutsche) were able to listen to their analysts and lower level traders assessment of risk and get out: "At Goldman, this isn't happening. When they [upper management] say get out, they get out. At Morgan Stanley, when Zoe says get out, people start negotiating." (Hogan 2010).

Listening to Cruz would have meant that Hubler, Tufariello, as well their supporters and cronies, would take the blame for the trade, or at the very least, not hit the numbers that were expected of them. According to my understanding of the corporate ethos, the only way Cruz could have saved herself, and the firm, was by finding another scapegoat or using provisional language to frame her substantive rationality as consistent with shareholder and the corporate ethos, a difficult task. Everyone involved understood risk. The risk was not that trade would blow up, because then people could claim misunderstanding, diffuse blame, and depend on the government to force a decision and pick up the pieces. Rather the risk was that people would be blamed internally for its results. Lewis reminds us that almost everyone involved in the deals that

blew up has signed a non-disclosure agreement, and also that "Morgan Stanley Traders are not quite as spooked as those who worked at Goldman Sachs, but they're close" (Lewis 204). It seem possible then, that some firms do find ways to make shareholder value work, or at least, make sure their firm is protected from the wreckage as well. Or it could be Goldman simply had the political connections to ensure it was bailed out, so looking out for its long term interest was not a part of the its employees decisions.

Looking at Goldman and Internal Communication about CDOs

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Goldman Sachs is seen to have a different culture than other banks, one more reminiscent of the partnership in pre-1980's Wall-Street. However these new partners "have the best of two worlds" because it is public, the firm can " raise large amounts of cash easily" but "it still takes care of its top people as if it were a private firm. (Craig 2006). This seems to suggest that the company is run for interest of its managers, not its stockholders. Most investment firms retain this partnership system. An employee at another firm describes becoming a partner as the goal of people who worked on Wall-Street, but notes Goldman's is considered the best: "it is the best corporate motivation tool I have ever seen," (Craig 2006). The article describes the motivation of keeping the program as "an effort to retain the clubby culture of old" but it also may help Goldman's leaders look out more for the long term health of the firm (Craig 2006).

Making the club requires an interview with a current partner with whom one does not have a relationship, it is a very secretive process even within the firm according to the article "Few candidates ever find out why they made or missed the cut" (Craig 2006). Those likely to make it are the top money-makers, referred to as "commercial killers" (Craig 2006). This is a public rationale consistent with shareholder value, and assumes that income produced for the

firm is an indicator of skill. However as one recent partner notes, it is more complex than just those who make the most money, and is certainly a political process: "My entire goal when I was up for partner was to not step on any land mines, keep my head down and continue to perform" (Craig 2006). Fortunately however, a large amount of internal documents from Goldmans CDO business have been released to the public as a result of investigations conducted by congress and the SEC.

The documents mostly pertain to a Goldman Sachs CDO, Abacus, and show yet another example of involving as many people as possible (investors, issuers, managers, advisers) on a deal in order to deflect risk and hide a conflict of interest. It highlights how these products in general spread risk around in a way consistent with the corporate ethos. Spreading risk is the stated purpose, but spreading risk around is done for a specific purpose in corporate life, to protect status quo and ensure those with power and responsible for decision making and or milking are not able to be blamed.

Abacus was a synthetic CDO that enabled hedge fund manager John Paulson to bet against the sub prime mortgage market (SEC Complaint 2010). However to do so required that Goldman find a counterparty, who would expect that market was not going crash, or at least that the assets in the CDO would retain their value. In fact, Lewis suggests, and the SEC supports, the idea that Paulson and Goldman both bet against the CDO, picked assets they thought were most likely to collapse, and used imprecise language and misleading statements to suggest to a firm called ACA, the counterparty, that they were on the long side as well.

Emails by the lead banker, show the extent to which he had internalized the corporate ethos and the lack of conflict between his interests and the creation shareholder value for his clients. Writing to an unknown friend, who would appear not be an employee of Goldman Sachs,

he summarizes his certainty about impending collapse state financial system and his relative safety:

> The whole building is about to collapse anytime now. Only potential survivor, the fabulous Fab [the author of the email]...standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!! (SEC Complaint, 2010)

He describes the thought process behind how these monstrosities, the CDOs were created: "Well, what if we created a "thing", which has no purpose, which is absolutely conceptual and highly theoretical and which nobody knows how to price?" This statement is odd for several reasons. The CDO, and ABS it was composed of it did have a purpose, to spread risk, but presumably he means no practical purpose. The goal was to create something that no one knew how to price, thus enabling the creator the ability to ensure it was profitable. This kind of thinking certainly enables one to fudge the numbers in the model, the kind Deutschebank was accused of doing, and many other firms probably did as well. However, whomever this hurts can make a big difference in how it is perceived, and who is prosecuted.

In a similar case, Credit Suisse, former head of global synthetic CDO's and two junior analysts charged with Fraud by US were accused of mismarking the ABS part of the CDO. An article in Bloomberg describes those involved as the world's dumbest traders, but they seemingly did the same things as others, albeit perhaps to a greater extent (Weil 2012). Their actions however did not result in a customer loosing money, but the bank, and thus made their bosses look bad.

These incidents suggest that the way Mackenzie posed the problem, as a technical one, is consistent with what managers would attempt to explain the problem as. Mackenzie's hypothesis is not mutually exclusive with mine. This may have initially been true, but it was soon realized

that the production of ABS CDOs and synthetic CDO (another form of secondary CDO backed by CDS) was a milking behavior. Just like in Jackall's firms, the degree of exploitation and irresponsibility varied based on firm specific dynamics, logistical, structural and social. That does not mean actors did not understand the essential nature of the fraud they were engaged in. Some understood less then others but this often was a product of misleading by those with knowledge, such as in the case of Zoe Cruz or ABA/Abacus Goldman. Ascertaining who knew what when is ultimately a futile exercise both because those involved have so much to lose, and because they have been trained to accept and explain a version of events designed to obscure this knowledge. They applied substantive rationality to save themselves and convinced themselves it was ok, even though understanding the danger of models could have prevented and mitigated the credit crisis. This is the rationality applied by Goldman and Deutsche, Paulson, Hubler and Tufariello and is rewarded in hierarchical American style bureaucracy corporations.

Understanding the role of these tools and functional rationality in actual decision-making becomes complicated because "vocabularies of rationality are always invoked to cloak decisions" especially ones that might been seen as ill advised, risky or impulsive (Jackall 79-80). In financial firms, one of the key metrics is the value of assessing risk, which is used by management as information for traders. Corporate employees need ways to hit the numbers desired by bosses in predictable and controllable fashions that will protect them if things blow up.

Chapter 4-Understanding the Response to the Crisis

The financial crisis has shaken up the financial industry. Bonuses are being cut or halted, profits are down, and according to journalist Greg Sherman, the industry is doing some "soul searching" (Sherman 2). Sherman, writing for NY Mag, in a provocatively titled piece about the castration of Wall-Street, sees regulations passed as part of the Dodd-Frank bill to blame for said emasculation. The piece itself has been attacked for inaccuracies about the effect of Dodd-Frank, but none the less appears to capture the sentiments of many in finance about the post crisis environment. Soul searching is used by Sherman to mean questioning if the ends being pursued are consistent with their values. It is a clear example of substantive rationality. However, that does not mean firms or individuals want to admit to past mistakes or acknowledge they acted out of self-interest.

The value cultivated by advancement in a corporate bureaucracy is, above all else, self-preservation for the individual. This value is pursued through all types of rationality, and is selected for; individuals who hold, for example, the social value produced by the corporation or its long term survival over self-preservation are used as scapegoats and stepping stones. This individual value must be translated into an organizational value in order to disguise the principal agent problem (that an individual or groups of individuals goals are not consistent with the organizational goals) and to ensure the functional rationality that gives bureaucratic corporations their economic advantage in pursuing ends that will maintain said advantage.

In the bureaucratic corporation, this is best done through the use of a conception of control. A conception provides a clear end to be pursued by the organization, and often becomes connected to a series of practices and strategies as well. These strategies or means, however, can change, as actors apply functional rationality to produce better methods of, for example, increasing share price. The importance of functional rationality is then two-fold, producing

benefits for the organization through increased share price and preserving economic advantage. For the individual (who has come to believe self-preservation is best achieved by avoiding decision-making, and when it cannot be avoided, applying functional rationality instead of substantive), this occurs by allowing the use of substantive rationality to be avoided whenever possible.

That does mean substantive rationality has no part in decision-making. I propose that (extrapolating from Jackall) in pursuit of self-preservation, individuals must learn to internalize the organizational values that will ensure their substantive (value guided) rationality is supported by their superiors and evaluators. Provisional language provides the tool to ensure these organizational values appear consistent with the bureaucratic ethos and individuals values, and help mitigate the cognitive dissonance created by the conflict between individual and organizational values. This modification of Jackall's model allows for more use of substantive rationality in the corporation, but only if it is guided by the appropriate values and uses the correct discourse.

A new dynamic emerged in financial firms because of their decentralized structure and the nature of highly leveraged trading (this explored in chap 2). Opportunities for wealth and power do not require continual advancement in the corporate hierarchy, and once a certain level of wealth and power has been attained, individuals can spin off into their own hedge fund, or operate as a subsidiary (as discussed in chapter 2). This shift has altered the corporate bureaucratic dynamic and the effectiveness of the conception of control for mitigating the principle agent problem. Additionally, the values produced by shareholder and financial control support these changes so long as share price and ROE increases. The values internalized or required for this level of success are still influenced by the conception of control, and neoclassical discourse. Efficient markets theory justifies the individual pursuit of profit as a

justifiable end, consistent with both the values of the conception of control and the corporate ethos.

There is growing call from business scholars and pundits to abandon the shareholder value model. However, they call for a new conception, or new goal of corporate activity, reflecting the theory established: when a conception of control no longer provides a predetermined end that enables self-preservation and organizational growth/economic advantage to be pursued concurrently with functional rationality, it must be updated or abandoned. Those calling for a new model are not writing from this perspective, but rather suggesting that the short-term focus produced by shareholder value has been detrimental to society and the economy as a whole.

This is not the first time that obsession with stock price has been blamed for economic catastrophe, as we saw in the 1980s. Remembering that crisis and the response of financial firms and the larger business community, we recall it seemingly showed that the creation of new means to pursue the new ends, that is substantive rationality, can occur without challenging the conception of control or producing substantive change in values. These new tools and techniques, and the structural changes that they facilitated, provided economic growth largely via financial growth and asset growth that had been an important part of shareholder value and financial conceptions of control. However, this substantive rationality did not prevent the emergence of an even larger financial bubble based on asset growth, even if it occurred via different means and with different stated ends. How much actors understood the similarities is unclear but as long as bureaucratic corporations require them to internalize beliefs designed to obscure the conflict of interests, and to accept this, we can imagine similar crisis will occur.

The 1980's crisis and response show that establishing new mechanisms and new goals for functional rationality can be achieved without changing the larger economic trends and patterns.

In the response to the current crisis, and the changes in finance since the 1980's, the question then becomes has the decentralized nature of finance and its unique corporate dynamic altered the values cultivated by the corporation.

Returning to Sherman, we can get a limited sense of some of the changes people in finance see occurring after the crisis, and the values being used to asses the crisis and find a way forward. Sherman notes that only now, 5 years after the start of the sub-prime scandal there is a "a growing recognition on Wall Street that the system that had provided those million-dollar bonuses was built on a highly unstable foundation" (Sherman 2). This statement does not question the tools used to create and evaluate derivatives or the system of Wall-Street leveraging but rather the foundation on which it was based. The flaws in foundation only identifiable because "bubble-bust-bubble seesaw of the past decade" and Wall-Streets bonus and compensation system are not the natural order of capitalism (Ibid 1).

A banker quoted by Ibid tries to find some formulate an objective reason for the crash saying even a banker from Mars "would see that these are institutions need to build up capital and that they're becoming lower-margin businesses"(Ibid 2). Of course the margins are lower only relative to the 1980's, and there is general theme among bankers who feel they are responsible for most of the progress since then. One says "never has there been a period of time of so little disease and so few wars and such growth of such absurd wealth" (Ibid). Still not many of those quoted defend the efficient markets theory and the role financial firms had in enabling it. There is a realization that at some point, their own efficiency/value creation stopped increasing relative to compensation. These perspectives mostly come from former Lehman bankers though. For example one notes "there's no other industry where you could get paid so much for doing so little" (Ibid 2) . In what does not seem to be a typical perspective, another former Lehman employee notes "Wall Street did a really good job convincing people it was really complicated

and they were the only ones who could do it and it justified paying them millions of dollars" (Ibid 3)

Sherman highlights the alternated corporate dynamic of financial firms, but contends that the Dodd-Frank legislation, specifically the Volcker Rule ban on proprietary trading has effectively separated hedge funds and speculative investing from banking. Now many top managers have left to start their own hedge funds unlike before where they could be independent groups still using the firm's money. This is especially true for Goldman Sachs (Ibid). How true this change is is actually unclear, and interpretation of the Volcker Rule is still very much pending. Sherman appears to reflect the prevailing opinion about the difference between Goldman and other banks explored in chapter 3. Goldman does better and was better prepared for the crisis, because it had "ruthless management" (Ibid 4) which was able to reign in rogue traders taking big gambles with the firms money. However, a recently penned piece by a disgruntled Goldman employee complicates that picture.

Greg Smith "Why I Am Leaving Goldman Sachs"

Greg Smith, an executive director at Goldman Sachs, wrote a scathing critique of Goldman Sachs' culture. It has created a massive amount of commentary in the financial world about balance between shareholder value creation, self-interest, and governance. His account provides tremendous insight into how substantive rationality functions in a financial firm, and the different interests to which it is applied.

Before exploring his piece, as well the public and the firms' reactions to it, it is worth mentioning the interesting timing of his departure. It comes 2 days of the hiring of a new PR director and firing of the outgoing PR director, who worked at Goldman for 12 years, just like

Smith (NY Times Deal Book March 2011). Interestingly enough, on a blog described by many as the leading financial industry tabloid, Dealbreaker[8], the most popular comment suggests the story presents a more complex picture. The comment accuracy is not what's being assessed, but rather the ideas it reflects about the awareness of financial professionals to distinguish between public objectives and private motivations, both at the individual organizational level. The comments suggest that Goldman Sachs controlled the timing and at least approved of letter in order to test its new PR staff, that the success of their response to this letter would be a "final interview." This comments popularity reflects the perception that Goldman is more rigorous in its selection of staff. It also reflects the extent to which public stories about finance are perceived to only capture half of the picture.

Replies to this comment (also highly rated) suggest a similar explanation, that is in fact, an outgoing member of PR[9] "strongly encouraged Greg to pen this letter" (Dealbreaker). The timing of this PR change and Smith's letter, are most likely conicidence, and there is no way to know if the commentators on this blog work at Goldman, let alone in finance. However this theory's popularity, on a blog that is leading source of insider information on Wall-Street, speaks to a complexity of motivations and rationales for any decision-making in these firms. Whether it was simply an astute observer noting the interesting timing and incorrectly connecting the dots is not as important as how plausible the idea that Greg Smith was not a disgruntled employee but a calculated risk by Goldman was to the readers. Most comments, and indeed the op-eds and stories papers such as the Financial Times, Forbes, and the WSJ are focused on describe Smith as

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8 Edited by Bess Levin, who Elle magazine, Forbes, and NY times describe as the most popular blogger among financial industry professional, and Matt Levine, an ex-Goldman employee who left the firm to work for the blog. Commenters frequently sign post with their position and/or firm. Comment: http://dealbreaker.com/2012/03/resignation-letter-reveals-goldman-sachs-is-in-the-business-of-making-money-hires-people-who-dont-know-how-to-tie-their-shoes/#idc-cover by guest rating +226

9 According to NYTimes Dealbook, besides longtime PR head Van Praag, 6 high level PR employees have left the firm in the past year.

a failed banker who blames the bank for his problems and supported the culture he now derides until he saw a chance to exploit populism and promote himself over his firm. As in the case of Merrill Trader Howard Hubler and his bosses, Cruz and Tufariello, the article and more importantly the response show that the motivations for decision-making are guided by values of personal interest, self-preservation (and promotion). This is accepted and embraced by employees of these bureaucratic corporations.

Smith's letter suggests his departure is motivated by his belief that he worked at Goldman long enough to understand the dynamics of its' culture and that the culture had become " as toxic and destructive as I have ever seen it" (Smith 2012). Specifically, he blames CEO Lloyd C. Blankfein, and president, Gary D. Cohn for loosing control of the firms' culture by allowing its "moral fiber" to decay (Ibid). For Smith, the source of this toxicity and decay is a system that supports and rewards individuals who put the profit-making of the firm above the best interests of the clients. Smith cites three key behaviors that secure advancement and success in the firm. To impress management, individuals can: sell "axes," that is products or investments which Goldman owns, but wishes to sell; "Hunt Elephants" which he translates as convincing clients to execute trades solely based on maximizing Goldman's profits; or successfully produce and/or trade derivatives and complex financial assets, which Smith describes as any "illiquid, opaque product with a three-letter acronym" (Smith 2012).

The malevolence of these behaviors are reflected in callous language directed towards clients, a subject which has been a theme of the legal investigations into the financial crisis. The case made against Goldman Sachs and Deutschebank (the two major banks that seemingly were able to foresee and profit from the fraud in sub-prime market) by the SEC depends in large part on email records that highlight the stark difference between the external opinion and advice of the firm versus its expressed internal beliefs (briefly explored in chapter 3). Indeed the

misleading nature of advice given by firms and the lies of omission revealed by emails and memos have been a key part of securities fraud since Enron. What Smith is especially upset by, is that despite these scandals, he still observes how "callously people talk about ripping their clients off" (Ibid).

He cites the Abacus case, where Goldman paid the largest settlement about ABS CDO fraud to date, but neither admitted nor denied wrong doing as a potential turning point in the firms culture. This is a crisis where substantive rationality could have been applied to punish those responsible for the fraud or misdeeds, but it was rewarded. The rationality was instead used to produce a way that appears superficially different to achieve the same end. He is appalled by the lack of humility when bankers referred to their clients as muppets. But it seems his decision to leave is more informed by his surprise at the values that guided the substantive rationality of Goldman's response to the crisis. Here was a chance for substantive rationality to be applied, guided by the values he thought Goldman Sachs valued "teamwork, integrity, a spirit of humility, and always doing right by our clients" (Ibid). He does not contend illegal behavior is or say it was going on, but rather that the actions and type of thinking that created the sub-prime crisis continue to be rewarded. This is a strategy that will ultimate undermine the trust of clients. Smith dealt many of the same products used to profit from the crisis, but is now realizing the hollowness of his internalization of the shareholder value definition of these products.

Smith also highlights how the functional rationality supported by the firm, and applied by junior analysts, cultivates the values he has come to abhor. Junior analysts are the specialists in functional rationality. Their job is not the question the logic of a superiors' demands but to come up with the most efficient way to meet them. This behavior is the only way to advance in the firm and is selected for. But analysts also learn to assess the values that guide their bosses' directives. This is an essential skill in a world of provisional language, where understanding what

your boss really wants, to please his boss by/and maximizing his ROE, is the only way to make sure your functional rationality is being applied to the right goal. In the case of derivatives (products like ABS CDOs, CDS, and other structured products) junior analysts have learned it is best to focus on one goal "How much money did we make off the client?" (Ibid). Smith is reflexive enough to realize new analysts are not somehow greedier than he was but that such questions are "a clear reflection of what they are observing from their leaders about the way they should behave." (Ibid). He does not propose a mechanism for how analysts internalize the values, but notes it "doesn't take a rocket scientist to figure out." Ten years of "hearing about "muppets', 'ripping eyeballs out' and 'getting paid' does not produce "a model citizen" (Ibid). He contrasts the functional rationality analysts are now taught to master with what he experienced. He suggests the goals from his superiors were achieving understanding of markets and financial tools and " getting to know our clients and what motivated them, learning how they defined success and what we could do to help them get there" (Ibid). It is plausible that, applying Jackalls notion of the corporate bureaucracy, internalizing the goals of management is essential to successfully applying functional rationality. However, formal rationality can only get one so far, and as one advances, and especially in crisis situations, it can leave individuals vulnerable to receiving blame, rightly or wrongly.

Being in a position to set goals allows limited control of evaluation (though as one advances, external parties are are source of evaluation and this is where mastery of conceptions of control become important). One must learn how to apply substantive rationality. Internalizing the values of top management (which are in turn influenced both by their process of advancement and the need to be consistent with a conception of control) helps ensure that exercising substantive rationality will be easier. We must remember of course that Smith

certainly encountered managers with goals of pleasing Bosses and maximizing profits, but that he believed they were the exception not the rule.

When Smith was first starting at Goldman, shareholder value was already well established as a conception of control but the difference, is how the firm pursued that goal and how that pursuit was evaluated. Making money, which Smith contends has now become the supreme goal, was valued, but it was balanced with a sense of professional responsibility, and the belief maintaining a clients first reputation was essential to producing shareholder value and making money in the long term. This is an evaluative framework that is still amoral, insider trading, if done without getting caught, fudging numbers, or other dishonest practices, were conceivably still acceptable if they did not affect persons or business who were paying Goldman for advice. Consider the description of an ex-Goldman employee of the fraud engaged in by Credit-Suisse in chapter 3. They were "stupid enough" to rip off their own firm instead of their clients.

However a cultural argument does not preclude a defense of corporate ethos and attempt to distort the causes of the crisis. It can blame and support formal rationality as substantive which is the essence of the corporate ethos. SEC Chairman Mary L Schapiro Remarks at SIFMA's Compliance and Legal Society Annual SeminarMarch 23, 2011 on Culture of Compliance:

> "And, without a commitment to good governance and risk management, silos can form and the interdependence between risk categories can be overlooked. What seems to be a manageable credit risk and a separate manageable liquidity risk may combine to do real damage ...Financial risk is inherent in market economies. Rational investors accept this. But the threats that discourage investors are often the products of shortcomings in structures, systems and culture, not the products of market dynamics. They keep clients from coming through your doors, they limit access to capital, they create inefficiencies, and they discourage individuals from acting in their own best interests. "

This perspective suggests that the problem in credit markets does not come from flawed products or the failure of shareholder value, but failed cultures where individuals (scapegoats) do not respect or use the tools properly or there is miscommunication and insulation that prevents management from understanding (silos). This argument is designed to support the belief that self-regulation works and risk taking needs to be encouraged, the corporate ethos, and uses the idea of structural problems that create cultural deficiencies to ensure shareholder value remains an acceptable conception of control. Cultural and structural problems that require a refinement of formal rationality, and because they cannot blame the ' efficient market' and its dynamics under shareholder value conception, instead use an agency theory-like explanation to suggest a better system of organization while allowing continued pursuit of shareholder value in rational markets. Instead of applying substantive rationality to question of credit crisis, they say things such as the numbers were fudged, decision-making was avoided, losses were expected to socialized, it applied to reconciling shareholder value with the corporate ethos.

Agency Theory and the Response to Crisis

Of course it entirely responsible that agency theory, and by extension shareholder value, will be modified to address the issues of the crisis. This could in theory work, but of course skepticism would be warranted as a new way to use agency theory to support to support the corporate ethos.

The Financial Times recently reported that Credit Suise has come up with a method it thinks will align the incentives of bankers and the shareholders. The CEO notes that after the crisis “the relationship between employee returns and shareholder returns is being scrutinised and criticised” (Braithwaite 2012). Bonuses will be paid using synthetic CDO's whose underlying products are linked to the success of the investments in the banks portfolio. Thus if these investments loose money, the bonuses decrease. This suggests a better way to implement

the formal rationality of shareholder value, and to address the conflict of interest, but it is only a partial solution at best.

As supporters of shareholder value ideology are undoubtedly saying, this type of behavior is supported by economics, and putting the interest of the bottom line above all of others is what makes a successful company. A recent piece in the Harvard Business Review expands about how to save financial economics usefulness from Wall-Street structural issues and thus sheds light potential way in which shareholder value will again be remarketed and reformulated.

This article attempts to answer the question of how to fix Wall-Street style capitalism, and not undermine neoclassical and financial economic theory, to avoid throwing the baby out with the bath water. It seems to be an expansion of a type of response advocated by the Greenspan quote from the introduction.

It analyzes the financial sector by noting its success is not measured by its effect on share-prices and asset growth, but "by how its serves the needs of U.S. households and firms, and by this standard its performance has been mixed." (Greenwood and Scharfstein 2012) While it has been beneficial for corporations, the author finds three main problems with contemporary finance. It is less stable than pre-1980's finance because there not have not been "adequate regulatory adjustments" to handle the shift to market-based from deposit based banking. It has been unproductive in its allocation of resources by investing too much in real estate compared to "more productive investments" (Greenwood and Scharfstein 2012, 1). Of course this was due in part to " generous government subsidies," Thirdly, it has charged "excessive investment fees" which has negatively affected household and resulted in the best and brightest being drawn into finance because of its immense financial rewards (Greenwood and Scharfstein 2012)

On the first point, the volatility seen since the 1980's is due in part to the growth of securitization coupled with " flaws in the credit ratings process"(Greenwood and Scharfstein

2012). The authors note this is based on a "compelling logic" that spreading risk around is better for the financial system and economy[10]. The goal of this article thus is not to question financial economics but rather provide better way of structuring and regulating it. Again, the authors find three flaws in the shadowing banking system itself. Shadow banking refer to the trading and production of products where a formal market, with canonical mechanism does not exist.

The first problem is the regulations for capital reserves (money to cover losses) for shadow banks were lower than the reserve required of traditional banks, resulting in regulatory arbitrage (Greenwood and Scharfstein 2012). This meant money flowed from the traditional banking system to the shadow banking, which did not have the funds to recover when faced with the defaults that occurred "when low-quality securitized loans began to go bad" (Greenwood and Scharfstein 2012) The loans are not described as misleadingly rated as high-quality, let alone fraudulent, making the blame simply about a technical problem of finding the proper loans to preserve ratios. This way of framing the problem is one of formal rationality not substantive rationality and thus is key to preserving the conception of control and avoiding blame to individual (firms or people) for irresponsible practices.

The second problem is the poorly understood nature of the risk created by the linkages of shadowing banking (Greenwood and Scharfstein 2012). This refers to the problem identified by Mackenzie, albeit with some superficial differences. Essentially it is how credit derivatives, hedging strategies, and the practice of retaining super senior portions of structured products often meant that spreading risk was not reduced risk but shared risk, multiplied by the degree of leverage. The authors did not suggest these practices should be stopped, only better understood.

The third problem is that despite not having deposits, shadow banks could still suffer a bank run of sorts, as other market participants withdrew short-term financing. This refers to the

10 (which type of risk is not defined but presumably default risk and prepayment risk)

final stages of the collapse of Lehman and Bear, who in addition to having clients remove their money, were unable to obtain financing from other banks. This type of bank run is a credit crunch. The problem the authors see is not that the risks taken were too great, but that without access to the cheap paper (low to zero interest bonds, the discount window) provided by the Federal Reserve to traditional banks and bank holding companies, the shadow banking system had to depend on itself for financing. Again the problem is not about irresponsible risks or poor decisions per se, but rather that the government to weather the natural cycles of the credit cycle did not support the system, and in a crisis, panic meant that the instinct for self-preservation (of individual firms) caused the whole system to unravel. This is advocating for a straightforward and standardized procedure for the losses of shadowing banking to be socialized.

The authors support the ambiguous problem of knowledge defense, though such crisis are still, unpredictable. This perspective exposed by the "top executives of financial services firms" is that " nobody could have predicted the magnitude of the crisis and that nobody will be able to predict the source of the next one" (Greenwood and Scharfstein 2012). This is a claim that no one can verify, but conveniently, it supports the typing thinking advocated by Greenspan in the introduction, it "strengthens the case for increased capital and liquidity requirements" (Ibid).

The problems with the housing market are in essence explained by likening the government to a drug maker, where the drug is easy credit, borrowers as hopeless addicts, and banks as middle men/dealers. The dealers would love to be, and are fully capable of, selling a better product if only the government did not make extending credit and exploiting regulatory arbitrage so cheap and profitable. In letting the dealers 'get high on their own supply' by not regulating them properly, the government is ultimately responsible for producing boom/bust (binge/crash) cycles. The authors suggest the popular solution of continuing or expanding government-sponsored mortgages is flawed and will continue the boom/bust cycle. The ideal

goal of reducing volatility, which of course is what the goal of policy was after the 1980's crisis, is supposed to be achieved by "weaning the housing market off government subsidies" (Ibid). This will work because of financial theory, and "the industry should focus on designing securities that deliver the fundamental promise of securitization—enhanced liquidity and diversification of risk—and not on those that arbitrage gaps in regulation" (Ibid). This again is framing the problem as one of instrumental-ism: something can be fixed by formal rationality when it is not skewed by misaligned incentives in the market.

Just as it is perfectly rational (in the economic definition) that finance would exploit this arbitrage in regulation (created by irrational or poorly designed regulations), the problem with the high fees charged by financial services firms is best explained by the irrational/poorly though out decisions of consumers. Despite "fierce competition" which should lower prices, financial services have been able to increase fees because of "consumers' lack of financial sophistication" (Ibid). The authors note that fund managers are able to take advantage of overall market growth by charging higher-fees, even if a passive strategy would have preformed just as well. Much like managers in the firms Jackall studied, who found taking credit for the work of others to be the most rewarding, financial firms have been able to increase revenue simply by establishing fees that do not depend on the success or failure of their own decisions. The authors refer to the successfully tested hypothesis that active management of funds, on average and adjusted for level of risk, is no better than passive management (Ibid). This theory however does not seem to consider that the perception and rating of risk is subjective and socially constructed and created the ratings arbitrage Mackenzie found.

The authors do note however the inefficiency of financial management, because fees, adjusted for market-capitalization (that is the amount money being managed), have remained largely constant since the 1980's, suggesting technology has not been used adequately to improve

assets management (Greenwood and Scharfstein 2012). Again recalling Jackall, that acceptable rates of return are socially determined, the expansion of market-capitalization, at least in part, seems to have been under-taken to maintain the fees while creating the appearance of improved performance. These fees, while remaining constant relative to market-capitalization, reflect an underlying assumption that higher value stocks costs are more to manage (Greenwood and Scharfstein 2012). This logic seems to be consistent with shareholder value defense of the corporate ethos, in that as share-price increases, bankers have created value, and are thus entitled to the same portion of the value created.

For an alternative perspective from the thinking produced by corporate bureaucracies we might look to smaller partnerships involved in finance. A partner at such a firm GMO, addressed the conflict of interest involved in investing, but acknowledged, and attempted to quantify, how the fear of keeping ones job. He contends that because professional investors are investing other peoples money "The central truth of the investment business is that investment behavior is driven by career risk." (Grantham 2012). As is the case in a bureaucratic corporation, the best way to prevent loosing your job is "to never, ever be wrong on your own" (Ibid).

He highlights how a financial performance ratio can actually be used to examine this, something that could be a useful method to examine the actions of corporate banks. The sharpe ratio, in his words, is "a reasonable, although short term,, measure of the chance real loss of money" and has been "portfolio management 101 for most of my investment career" (Ibid). However this ratio is rarely used in practice by professional investors. In contrast the "information ratio" aka "benchmark risk" which he defines as a "measures the risk of embarrassing your boss and losing your job" is use widely (Grantham 2012). This type of analysis could provide very dangerous to corporate bureaucracy and shareholder value but in general this chapter shows it is being defended and modified.

Applying the theory of bureaucratic corporation to contemporary financial corporations and banks, response to the crisis the purpose of the chapter. Specifically, how the ideologies and mythologies identified by Karen Ho, which are in turn reflections of shareholder value conception of control took on new forms. It also gives an account also gives insight into an age old problem that is at the core of hierarchical bureaucratic organization and continually takes new forms, the conflict individuals interest and the firms. Self-interested short term focus, what was rewarded, and it was only a problem for individuals who could not accrue enough social capital to outrun their mistakes, and the conception of control that enabled appear poised to continue, though there is evidence of major change to come

Conclusions

Bureaucracy promotes formulaic thinking and action over critical thinking and requires actors to internalize the logic that guides the corporation. It also supports irresponsibility and allows the corporation to run in interest of its top managers. In Weberian terms, these dynamics result from formal rationality dominating substantive rationality. The conflict of interest is obscured through language and conception of control.

The logic internalized by banks is called shareholder value, which is grounded in economic theory and suggests short focus and self-interest can produce collective good. This allows the corporate bureaucracy to disguise the conflict of interest between those who run and its larger social role. The crisis can be understood as an example of corporate ethos reproducing itself on organizational level, although because it spread risk across the whole system, and scapegoat mortgage borrows and consumers, the consequences affected a larger group.

This privation of benefit and socialization of loss is problem that will remain, despite what banks and shareholder value defenders may claim. Shareholder value discourse not only disguised and obscured the conflict of interest between the banks owners and their managers, it convinced them that their interests were aligned. In context of a bureaucratic corporation, it made impossible for the people who were the engine of securitizations machine to appreciate the consequences of their actions, or what would happen when it blew up, and those in the position is do something about it unable and/or unwilling to fix the machine or stop it. Those trained in the values of this system will look for new ways to continue similar tactics and thus retain stability and power, though there some encouraging signs this is changing, the nature of bureaucracy means more detailed study is needed.

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