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Banking Ethics and the Goldman Rule

John P. Watkins

Abstract: Insulating people from the effects of the crisis has left intact the habits of thought and the basic institutional structure. The continued reign of pecuniary values leaves intact the Goldman Rule: *pursue profitable opportunities regardless the effects on others.* Within a culture dominated by pecuniary values, profitable opportunities present a coercive force. Laissez-faire policies allow profitable pursuits without restraint. Subprime mortgages offered an opportunity to tap a new source of profits, namely, the increase in housing prices. Many financial institutions engaged in unscrupulous actions to convert household wealth into corporate profits. Efforts to reign in the industry remain wanting.

Keywords: acquisitive society, banking ethics, banking profits, Goldman Sachs, subprime crisis

JEL Classification Codes: A13, B25, B26, D63

The bailout of the banks violates the legitimacy of markets, the ethos that profit represents the reward for success, loss the punishment for failure. The outrage over bailouts combined with insulating people from the effects of the crisis has fostered an anti-interventionist reaction and a resurgence of neoliberalism. Insulating people from the effects of the crisis has largely left intact the habits of thought and the basic institutional structure. The continued reign of pecuniary values leaves intact the Goldman Rule: *pursue profitable opportunities regardless the effects on others.*

The Goldman Rule rests on the assumption that increases in profitable opportunities increase the opportunity cost of ethical behavior. Ethical behavior refers to self-imposed actions to avoid taking advantage of others that result in lower profits. The Goldman Rule suggests that financial institutions are less likely to engage in ethical behavior where the opportunity cost of such behavior is high.

Banks pursued making subprime loans to tap a new source of income without regard to the effect such loans might have on debtors. Banks provided subprime loans

John P. Watkins is a professor of Economics at Westminster College in Salt Lake City, UT. *This paper was presented at the annual meeting of the Association for Evolutionary Economics, January 7-9, 2011 in Denver, Colorado.*

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assuming a continual rise in home prices. The collapse in prices precipitated the collapse in banking profits, prompting a call for bailing out the banks. Government bailouts effectively rewarded financial institutions for "bad" behavior. Hence, meaningful institutional change required to reign in the financial sector remain wanting.

The Banking of Ethics

Banking is a peculiarly capitalist activity. The purpose is profit; the means is through the purchase and sale of debts: government securities, commercial paper, consumer loans, and so on. Banks purchase debts (assets from the bank's point of view) with cash or spendable IOUs. Spendable IOUs represent a promise redeemable for cash or some other acceptable asset. To fulfill these IOUs, banks must obtain cash or the spendable IOUs of other banks either by liquidating assets or acquiring liabilities through deposits or borrowing. Profits stem from the income earned from interest and fees less the interest paid and operating expenses.

During medieval times, the Scholastics considered banking unethical. They viewed charging interest a sin against God punishable by eternal damnation.[1] The Scholastics could not reconcile charging interest with the idea that economic activity should serve a moral end. Charging interest appeared to take advantage of the needs of others, behavior contrary to the medieval notion of a functional society. In brief, interest placed the money lender above the social interest (Tawney 1926).

Following Aristotle, the Scholastics considered money barren. They viewed money as a means to procure the goods and services necessary to live a virtuous life. They viewed the pursuit of money as an end in itself contrary to nature. For within nature, everything has a beginning and an end; the pursuit of money begins with money and ends with money in a neverending process.[2]

The Goldman Rule

Laissez-faire policies foster a belief that individuals and organizations may pursue pecuniary values without restraint. For individuals lacking ethical considerations there is no tradeoff. There is only a single minded pursuit of profit. In Milton Friedman's view, the only ethical issue is how an individual allocates his property.[3] Ayn Rand, Alan Greenspan's intellectual mentor, precisely summarized the ideology underlying the Goldman Rule.

> I work for nothing but my own profit — which I make by selling a product they need to men who are willing and able to buy it. I do not produce it for their benefit at the expense of mine, and they do not buy it for my benefit at the expense of theirs; I do not sacrifice my interest to them nor do they sacrifice theirs to me; we deal as equals by mutual consent to mutual advantage. (Rand 1957, 451)

For those for whom ethics plays a role, the pursuit of pecuniary values suggests a tradeoff between profitable opportunities and social ethics, a tradeoff that underlies the Goldman Rule. The greater the profitable opportunities, the more likely individuals and organizations will engage in behavior without regard for the broader consequences.

The logic provided by Douglass North (1990) helps clarify the argument. North argues that in open societies individuals may express themselves freely. Since the opportunity costs of expressing one's opinion is minimal, individual choices reflect personal opinions. In closed societies, however, the opportunity cost of expressing one's opinion is high. Governments force individuals to make choices based not on personal opinions, but coercion.

North missed, however, that open societies based on the market also have a coercive element. The market culture and the associated mentality create a coercive force that runs in pecuniary terms, a force that becomes stronger where alternative economic institutions — reciprocity or redistribution — are lacking or weak. As Karl Polanyi (1944) noted, the creation of a market economy in the nineteenth century made the promise of gain and the threat of hunger motivating forces. In such cases, the dominance of the market both fosters and forces a pecuniary mindset. Misunderstanding, ignorance, or indifference exacts its own punishment as does charity, good will, and generosity.

For a very few, the market presents opportunities for untold wealth. Under such an institutional setting, the coercive force is the opportunities forgone. From the point of view of the Benthamite calculus, there is no difference between the distress from government coercion and the distress from opportunities lost. "Quantum of pleasure the same, pushpin is as good as poetry" (Bentham 1973). The greater the profitable opportunities, the greater the coercive force. Ethics be damned. R.H. Tawney referred to such societies as "Acquisitive Societies," for their purpose "is to promote the acquisition of wealth" (1920, 29).

> The secret of its triumph is obvious. It is an invitation to men to use the powers with which they have been endowed by nature or society, by skill or energy or relentless egotism or mere good fortune, without inquiring whether there is any principle by which their exercise should be limited. It assumes the social organization which determines the opportunities which different classes shall in fact possess, and concentrates attention upon the right of those who possess or can acquire power to make the fullest use of it for their own self-advancement, the hope that they too one day may be strong. Before the eyes of both it suspends a golden prize, which not all can attain, but for which each may strive, the enchanting vision of infinite expansion. It assures men that there are no ends other than their ends, no law other than their desires, no limit other than that which they think advisable. Thus it makes the individual the center of his own universe, and dissolves moral principles into a choice of expediencies. (Tawney 1920, 30)

The opportunities offered from issuing subprime loans proved too great a temptation. Securitizing those loans and passing off the risks to others provided an even greater temptation. Under laissez faire policies of the Clinton and Bush Administrations, unethical behavior produced windfalls.

The Goldman Rule in Action

The Goldman Rule obviously refers to the behavior of the most profitable of the Wall Street Banks, Goldman Sachs. Goldman Sachs engaged in ethically questionable activities that generated enormous profits. Goldman Sachs successfully persuaded AIG to sell Goldman Sachs credit default swaps for which it earned $14 billion, courtesy of U.S. taxpayers, while Goldman Sachs securitized the subprime mortgages, selling them to unsuspecting investors. In April 2010, the Securities and Exchange Commission claimed Goldman Sachs "sold investors a subprime-mortgage investment that was secretly designed to lose value."

The unraveling of the U.S. economy began with the collapse of the subprime market. The subprime lending market provided a relatively new, untapped source of potential profits. "The defining characteristic of a subprime mortgage is that it is designed to essentially force a refinancing after two or three years" (Gorton 2008, 12). Subprime loans offered low initial interest rates, teaser rates that subsequently adjusted upward requiring the borrower to either refinance or pay off the mortgage. The market rested in part on the desperation of households, in part on the appreciation of housing prices, in part on declining interest rates. The appreciation of housing prices enabled low income earners to refinance to pay off credit cards, car loans, and other personal debts. "The purpose was to extend credit to less and less creditworthy homeowners, not so that they might buy a house but so that they could cash out whatever equity they had in the house they already owned" (Lewis 2010, 21).

From the point of view of the mortgage industry, subprime mortgages offered an opportunity to tap a new source of profits, namely, the increase in housing prices. Subprime mortgages provided a means to convert household wealth into corporate profits. "The subprime mortgage loan was a cheat. You're basically drawing someone in by telling them, 'You're going to pay off all your other loans — your credit card debt, your auto loans — by taking this one loan. And look at the low rate!' But that low rate isn't the real rate. It's a teaser rate" (Lewis 2010, 30-31). The appreciation in home prices made subprime loans appear riskless. If people default, banks receive the value of the home, an asset that exceeds the loan's value. Moreover, the structure of subprime mortgages provided fees to banks since the loans needed to be refinanced regularly. Prepayment penalties further protected creditors from efforts of homeowners to roll over their loans to obtain lower interest rates. Banks could further reduce risks by securitizing the receivables. "Make the loans, then sell them off to the fixed income departments of big Wall Street investment banks, which will in turn package them into bonds and sell them to investors . . . By early 2005 all the big Wall Street investment banks were deep into the subprime game. Bear Stearns, Merrill Lynch, Goldman Sachs, and Morgan Stanley all had what they termed 'shelves' for their subprime wares" (Lewis 2010, 34).

Some Data

Table 1 indicates the return on equity of various bank categories: banks having assets exceeding $10 billion, banks having assets between $1 and $10 billion, and banks having assets between $100 million and $1 billion. The table further includes two of the largest mortgage banks, Washington Mutual (WaMu) and Countrywide, in addition to Goldman Sachs.

From the last quarter of 2005 to the third quarter of 2007, the largest banks consistently had the highest returns. Countrywide in particular received above normal returns up to the third quarter of 2007. Both Countrywide and WaMu were known for their aggressive tactics in making subprime loans. The strategies paid off, until the last quarter of 2007. By the third quarter of 2008, both Countrywide and WaMu incurred losses resulting in a negative return on equity exceeding 30%.

Table 1. Return on Equity

Quarter	100M-1B	1-10B	10B+	Country-wide	WaMu	Goldman Sachs
3/31/2006	11.54%	13.14%	14.14%	18.85%	14.20%	23.98%
6/30/2006	12.37%	13.36%	14.04%	17.17%	12.96%	27.63%
9/30/2006	12.59%	13.11%	13.84%	19.61%	12.57%	26.68%
12/31/2006	12.14%	12.58%	13.36%	19.74%	11.87%	29.90%
3/31/2007	11.53%	11.39%	12.39%	17.41%	12.63%	31.16%
6/30/2007	11.56%	11.14%	12.55%	13.47%	12.89%	29.25%
9/30/2007	11.12%	10.47%	11.70%	3.02%	9.84%	31.77%
12/31/2007	10.11%	9.10%	9.08%	1.02%	0.99%	29.52%
3/31/2008	8.50%	8.04%	6.32%	-15.60%	-17.02%	24.93%
6/30/2008	7.19%	4.97%	4.85%	-36.39%	-34.05%	23.22%
9/30/2008	5.02%	3.13%	4.45%	8.48%		18.08%
12/31/2008	2.85%	-2.06%	1.57%	7.25%		4.33%
3/31/2009	3.19%	-2.08%	2.96%	22.25%		4.94%
6/30/2009	0.88%	-5.16%	1.39%			7.38%
9/30/2009	0.86%	-3.47%	1.31%			11.39%
12/31/2009	-1.15%	-3.96%	1.39%			19.82%
3/31/2010	3.93%	0.95%	5.32%			22.02%
6/30/2010	3.68%	1.40%	6.04%			17.87%
9/30/2010	4.15%	2.03%	5.29%			15.48%

Source: FDIC: Statistics on Depository Institutions. Available at www2.fdic.gov/sdi/main.asp. Accessed December 16, 2010.

Table 2 indicates the ratio of consumer loans to total loans and leases for the different size banks. Again, the largest banks had the largest percentage of consumer loans. Consumer loans include personal loans, mortgage loans, credit card loans, and auto loans. There appears to be a correlation between consumer loans and return on equity. For Countrywide, consumer loans as a percentage of total loans exceeded the average for large banks. Most of their loans, of course, comprised mortgages.

In part, the greater profits accruing to the mortgage banks stemmed from their willingness to assume greater risks. One measure of risk is indicated by the ratio of

Table 2. Ratio of Consumer Loans to Total Loans and Leases

Quarter	100M-1B	1-10B	10B+	Country-wide	WaMu
3/31/2006	0.37	0.41	0.69	1.00	0.87
6/30/2006	0.36	0.39	0.68	1.00	0.86
9/30/2006	0.36	0.39	0.68	1.00	0.86
12/31/2006	0.35	0.39	0.69	0.99	0.84
3/31/2007	0.35	0.39	0.67	1.00	0.82
6/30/2007	0.34	0.38	0.68	1.00	0.82
9/30/2007	0.34	0.37	0.67	1.00	0.82
12/31/2007	0.34	0.37	0.67	0.99	0.81
3/31/2008	0.33	0.37	0.66	0.97	0.81
6/30/2008	0.33	0.37	0.66	0.99	0.80
9/30/2008	0.34	0.36	0.66	0.98	
12/31/2008	0.34	0.37	0.67	0.98	
3/31/2009	0.34	0.37	0.68	0.97	
6/30/2009	0.34	0.39	0.68		
9/30/2009	0.35	0.40	0.69		
12/31/2009	0.35	0.39	0.72		
3/31/2010	0.35	0.40	0.80		
6/30/2010	0.35	0.40	0.79		
9/30/2010	0.36	0.40	0.78		

Source: FDIC: Statistics on Depository Institutions. Available at www2.fdic.gov/sdi/main.asp. Accessed December 16, 2010.

loans to core deposits, deposits having less than $100,000 (Table 3). Core deposits are less costly than large deposits generally made by various financial institutions. Banks pay a lower interest on core deposits, and there is generally less turnover. Both Countrywide and WaMu maintained a much higher ratio of loans to core deposits, followed by banks with assets exceeding $10 billion. Such high ratios required other, more costly sources of financing, thereby increasing their fragility.

By 2007, the return to equity of the mortgage banks had fallen considerably. By 2008, Washington Mutual had collapsed and Countrywide had been absorbed by Bank of America.

Table 3. Ratio of Net Loans and Leases to Core Deposits

Quarter	100M-1B	1-10B	10B+	Country-wide	WaMu
3/31/2006	1.04	1.17	1.35	2.49	2.49
6/30/2006	1.06	1.18	1.39	2.55	2.38
9/30/2006	1.08	1.21	1.41	2.33	2.21
12/31/2006	1.07	1.22	1.39	2.27	2.26
3/31/2007	1.05	1.17	1.38	1.61	1.36
6/30/2007	1.07	1.19	1.42	1.51	1.36
9/30/2007	1.09	1.20	1.48	1.67	1.46
12/31/2007	1.10	1.21	1.47	1.74	1.54
3/31/2008	1.09	1.22	1.43	2.14	1.47
6/30/2008	1.11	1.24	1.43	1.76	1.38
9/30/2008	1.11	1.23	1.40	1.75	
12/31/2008	1.10	1.19	1.26	2.26	
3/31/2009	1.08	1.16	1.22	2.73	
6/30/2009	1.07	1.13	1.19		
9/30/2009	1.06	1.11	1.13		
12/31/2009	1.03	1.06	1.08		
3/31/2010	1.01	1.04	1.11		
6/30/2010	1.01	1.03	1.10		
9/30/2010	0.99	1.00	1.08		

Source: FDIC: Statistics on Depository Institutions. Available at www2.fdic.gov/sdi/main.asp. Accessed December 16, 2010.

Bank Reform and the Lack of Institutional Change

Oddly, the bailouts that are an anathema to the spirit of neoliberalism may have provided the basis for its resurgence. As Veblen observed, "[a] readjustment of men's habits of thought to conform with the exigencies of an altered situation is in any case made only tardily and reluctantly, and only under the coercion exercised by a situation which has made the accredited views untenable" (Veblen 1953, 192-193). The bailout effectively removed "the coercion exercised by a situation." In particular, the crisis and the subsequent bailouts left the banking interests largely intact. "If any proportion of class of society is sheltered from the action of the environment in any essential respect, that portion of the community, or that class, will adapt its views and its scheme of life more tardily to the altered general situation; it will in so far tend to retard the process of social transformation" (Veblen 1953, 193).

The bailout poses a paradox: the very policy designed to mitigate the effects of economic crises exert a conservative force upon society, impeding progressive economic change. The very institutions that effectively averted depression enable the resurrection of the very ideas that helped precipitate the crisis.

This sheds light on the recent Basel agreements to avoid future financial crises. While the regulations permit banks to take risks, the proposed regulations raise the capital requirements. Basel 3 seeks to limit the ability of banks to leverage capital. The logic is that larger capital requirements will provide a greater cushion for future losses. Whether the requirements are sufficient to avoid future crises seems doubtful.

Many have pointed out the problems with Basel 3. Banks have until 2019 to comply with the new requirements. The proposal does not address the problem of too-big-to-fail. Nor does it limit bank activities or address their social purpose. Basel 3 leaves intact the institutional structure that existed before the crisis (Damian and David 2010).

The housing boom and the subsequent crisis remind us again that excessive profits evokes excessive behavior. The Goldman Rule raises the question, raised throughout humanity's experience with the market institution, whether society should limit profitable opportunities. The Basel proposal suggests that society should not.

Notes

1. "To take usury is contrary to Scripture; it is contrary to Aristotle; it is contrary to nature, for it is to live without labor; it is to sell time, which belongs to God, for the advantage of wicked men; it is to rob those who use the money lent, and to whom, since they make it profitable, the profits should belong" (Tawney 1926, 43).
2. Writes Marx: "The simple circulation of commodities — selling in order to buy — is a means of carrying out a purpose unconnected with circulation, namely, the appropriation of use-values, the satisfaction of wants. The circulation of money as capital is, on the contrary, an end it itself, for the expansion of value takes place only within this constantly renewed movement. The circulation of capital has therefore no limits" (Marx [1887] 1954, 150).
3. "Indeed, a major aim of the liberal is to leave the ethical problem for the individual to wrestle with. The 'really' important ethical problems are those that face an individual in a free society – what he should do with his freedom" (Friedman 1962, 12).

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