

Leadership, Business Schools and Financial Crises: The search for a missing link

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ABSTRACT

Business schools produce leaders who command 'power' and 'governmentality', as per Foucault's theoretical conceptualisations, to institutionalise routines and social practices in contemporary organisations. These leaders must uphold ethics in their business decisions; however, this has not been reflected in many instances, as recurring financial crises have depicted over time.

Efforts to address the issue and reach its root cause have failed to deliver concrete results so far, which necessitates an objective probe into today's business education. This conceptual-cum-analytical paper proposes an alternate, indirect approach to effectively tackle the issue.

We suggest two remedies: first, transformative teaching and learning activities that inculcate ethical values into students should be implemented at the grass root level – primary and secondary schools, that feed into business schools with future business leaders; second, a conducive corporate governance environment within business organisations that supports ethical decisions and nurtures ethical behaviour needs to be developed – arguably the first being the prerequisite for the second.

Introduction

Deducing an optimal solution to a problem requires a thorough and objective understanding of the problem's root cause(s). The occurrence of financial crises around the world has become a cyclical phenomenon, with people expecting such crises every few decades. Whether we speak of the 1929 Great Depression, the largest one-day stock market plunge of 1987 in the US, or the 1989 Japan crisis, the fraudulent and/or unethical practices of big players in the finance world – the banks' and large corporations' executives – frequently have had a role in causing the harm. Regulatory frameworks, work ethics models, law-enforceable standards, criminal courts, audit requirements and severe punishments, among other measures, have been operative for at least two decades.

Business schools around the world have been teaching sustainability and ethics as crucial elements of their curriculum, but it appears something is still missing. CPAs' unethical decisions played a significant role in the major corporate collapses in the recent past, which also tarnished the accounting profession's image (see Konishi, 2010). Moreover, lessons learnt from the financial crisis of the early 2000s did not result in measures that could prevent the late 2000's financial crisis, and again, if reasons are not pondered upon *objectively*, without tackling the 'real but difficult' ones, the world cannot be confident the crises will not occur again.

While the contribution of financial market players around the world to the financial crises cannot be denied, primarily the recent financial crises in the US, being an economically dominant country with dependents all over the world, translated into the financial crises around the world. The reasons given in the 2011 Financial Crisis Enquiry Commission's final report, while not explicitly blaming its education system for producing 'qualified' graduates whose very decisions led the world to this crises, does, however, point to the unethical and immoral decisions taken by the people who ran the country's financial system. There was 'a systemic breakdown in accountability and ethics' and a sheer neglect of the standards of responsibility and ethics greatly contributed to the financial crises and eroded public trust in the financial system, the report adds. Business schools produce future business leaders, and a deeper analysis of the reasons behind financial crisis, based on logical reasoning, reveals that a major part of responsibility could be traced to the business schools that produced these 'qualified' graduates and the 'missing link' in their curriculum that produce otherwise competent business graduates. From the point of view of sustainability, the unethical, reckless and immoral decisions taken by graduates of renowned business schools around the world, and their direct and indirect repercussions in the form of the seemingly unstoppable environmental degradation and the ever-repeating financial crises, again point to a missing link in our education system (for critical challenges facing business schools in the post-financial crisis era (Datar et al., 2011; Currie et al., 2010; Wallace, 2010).

Incidents like the 1984 Bhopal disaster in India, apparently caused by poor maintenance by the Union Carbide Company, that resulted in the poisoning of thousands of innocent people; the contamination of the underground waters around Sydney by the ICI; the Ok Tedi Mine contamination of the Fly River that affected around 50,000 people; or the Chernobyl nuclear reactor accident that still has its 'signs' across Ukraine and western Europe mostly could have been avoided, had 'ethics' and 'morality' been dominant in the leadership business executives evidenced in their day-to-day business decisions. Financial crises in under-developed or developing nations could be blamed on weak regulatory frameworks and law-enforced standards, but the recent crises, hitting both developing and developed nations, have demonstrated that having strong regulatory frameworks and law-enforced standards alone cannot guarantee the efficient and ethical functioning of financial markets. This means that another financial crisis could be looming.

This conceptual-analytical paper argues that reviews of each episode of financial crises for causes and remedies that could help prevent or mitigate the effects of a future episode seem to have been missing a major link to the root cause(s). The rest of the paper is divided into three main sections, each with sub-themes: *first*, a review of the literature is carried out with a view to highlight the significance of the issue and the lack of a concrete solution to effectively tackle the problem.

The *next* section reviews the phenomenon from the perspective of established theoretical constructs – Foucault's conceptualisation of 'power' and 'governmentality' and DiMaggio and Powell's (1983) institutional theory – followed by a final section on discussions and conclusions. Logic- and theory-deduced propositions to help guide future empirical research in the area are put forth throughout the paper.

Financial Crises – A Review of the Literature

We would like to make a point that a wide body of the literature has endeavoured to address the issues of financial crises and their causes and remedies, but little, if any, has been said about the lack of a full appreciation of ethical standards by the graduates of the so-called renowned Business Schools around the world – an issue that we bring to the attention of policy-makers through this article. Parts of the literature do point to unethical, immoral and/or incompetent decisions taken at various levels in business organisations and within regulating agencies – a phenomenon termed as 'a fundamental intellectual failure' by Currie et al. (2010: S1). However, this paper aims to steer policy-makers' attention to an indirect but important cause of these unethical and immoral decisions, thereby filling the current void in the literature.

A capitalist economy is always overextended in terms of debt when viewed through the lens of informational instability. It is understandable that when commercial banks heavily resort to demanding deposits to finance their long-term investment projects, only the stability of information in financial markets can keep banks' credit portfolios safe from deterioration in quality (Bernanke et al., 1996). In normal circumstances, when capitalism is calm and behaves in a rational manner, the economy can be said to be in equilibrium, in general terms. During this stage we find that until a big shock of negative information is uncovered capitalism carries on with its normal business. However, the moment they (the capitalists) realise or perceive, taking input from various sources of information, that things are not quite right they run for cash, thereby pushing banks off their feet. The reason being that the magnitude of liquidity in a capitalist economy in post-crisis times is always disproportionate to the magnitude of liquidity in pre-crisis times, due to price and debt deflation (Fisher, 1933; Wolfson, 1996). Hence an informational (confidence) shock, big enough to move capitalists, is what brings a change to the market equilibrium. The conditions for this shock are laid in pre-crisis times in the shape of (credit) bubble formation.

Prices and quantities of products and services always vary in an economy under the forces of demand and supply, so there are always sustainable oscillations in different sectors (Fisher, 1933). The 'bubble' sector is the one which breaks the sectoral economic rhythm, and leaves its normal orbit in the pre-crisis times (booming economic activity). The difference between the energy levels of the 'bubble' sector's two orbits – the pre- and the post-crisis – is the function of forces of key players in the financial system (Keynes, 1936; Minsky, 1986). 'Politicised' groups within commercial banks' management, and authorities in the central banks, bond together and respond, seducing the former groups to finance credit with credit, encouraged by the prevailing low interest rates. As a result, prices in the bubble sector shoot up, so credit rating agencies' reports and innovative financial products prompt international investors to jump in, thereby further fuelling the extensive credit activity in the sector (Jensen & Meckling, 1976). Unsustainable credit levels in this bubble

period finally collapse with a force that 'moves' capitalists to run for their cash, thereby bursting the 'bubble'. Confidence in the financial sector suffers as a whole, and bad as well as good credit bears the brunt. The primary aspect that is relevant to this paper is that players in the financial markets – businesses' and banks' management teams – rather than economic forces, have a role in the formation and subsequent extension of the 'bubble' sector in the first place. In other words, the financial system, being at the centre of the economic system, is responsible for overextended credit activity creating the 'bubble'.

Financial crises have occurred in almost all major parts of the world with varying degrees of intensity, leaving behind overall economic lapses. Starting with the Great Depression of the 1920s in America, the Japanese financial crisis in the 1980s, the Asian crisis in the 1990s, the South East Asian, European, and the Mexican crises of the 1990s, and recently, the early- and then the late-2000s crises. The occurrence of these crises has been frequent and systematic; yet another one is looming over the horizon. Figures show costs of these crises are threatening. In Asian countries non-performing loans amounted to 30 per cent of banks' total assets. In 25 per cent of financial crises cases, costs of banking crises rose to about 10 per cent of GNP in the case of different European countries. In individual countries the figures are even more worrisome (Llewellyn, 2002: 153). Initially, the cost of the current financial crisis in the US, that was instigated in the first quarter of 2006 with the turning of the housing market (Acharya et al., 2009), was predicted by the Federal Reserve chairman, Ben Bernanke, to be \$50-100 billion. In February 2008, Greenlaw et al. (2008) forecast these costs to be \$500 billion, and in April and October the same year the IMF (2008b) forecasts skyrocketed to \$950 billion and \$1400 billion respectively (Barrell & Davis, 2008). Financial crises have been a common phenomenon specifically since the 1970s. Making different definitions of 'financial crises' as a base, Demircuc-Kunt and Detragiache (2005) and Caprio et al. (2003) found 77 and 117 cases respectively of banking crises during periods 1980-2002 and 1970-2002. Caprio et al. (2003) also found 51 cases of borderline and non-systematic cases in 45 countries over the same period. Furthermore, Davis and Karim (2008) outlined seven systematic crises in the period 1980-2000 in the Organisation for Economic Cooperation and Development (OECD) countries and also some minor crises in the US, Portugal, and Italy. The financial crisis of 2007-08 has been the greatest since 1929-33 leading to large scale economic downturns across the globe.

Some of the causes of financial crises outlined in the literature include two distinct dimensions – 'fundamental causes' and 'self-fulfilling prophesies'. Both of these dimensions relate to the complementary process of information acquisition through open market participation. All of this process is dependent upon the acquisition of information by market participants (Nikitin & Smith, 2008). Information-acquisition-based analysis of the 'bank run' has been carried out by Chen and Hasan (2008) who label it: 'panic bank run'. In times of crisis, even banks with sound financial footings, experience 'runs', which suggests that depositors may rush for withdrawals solely because of information propagation. In panic runs, the quality and reputation of a bank becomes secondary because of the depositors' flight to safety. These facts suggest that financial crises have been a common phenomena, which has been decelerating and freezing financial systems across the globe.

A Scholarly Perspective on Some Episodes of Financial Crises

Bernanke (1995: 1) notes,

... Not only did the Depression give birth to macroeconomics as distinct field of study, but also – to an extent that is not always fully appreciated – the experience of the 1930s continues to influence macroeconomists' beliefs, policy recommendation and research agendas.

The shift in thinking about the real causes of crises is relatively recent. The determination that domestic money supply affected the level of prices is a convincing argument to explain the causes of the Great Depression. In respect of the decrease in aggregate demand for goods and services during the great economic turmoil, it became evident that the initial money contraction caused by political and economic short-sightedness, resulted in a decreased output. On the supply side, *debt-induced* financial crisis and non-adjustability of nominal wage due to the monetary contraction, affected output (Bernanke, 1995). Thus, the monetary forces were responsible for the demand contraction and the resultant crisis. The more we broaden our analytical perspective by focusing on different areas of concern and the multidimensional nature of the underlying problems, the less the chance of explaining these problems in a more systematic manner. For instance, when the Great Depression was analysed in the 1960s and 1970s, the focus was primarily on either the monetary or real economic forces. Further, the analysis was marginalised by concentrating on just the case of the US. Sole focus on the statistics of just one data context gave rise to long standing controversy, which also points to the research gap in respect of the real causes of financial crises that may be found by resorting to qualitative research analyses. Friedman and Schwartz (1963) and Temin (1976) provide two contrasting conclusions, with the former emphasising US Federal Reserve and monetary aggregates as responsible for the intensification of the Great Depression, while the latter regards real economic shocks around the world to be the real cause, thus undermining the role of monetary policy in the unfolding of economic disasters.

The long standing controversy about the causes of the Great Depression has been attributed to the data itself. The literature indicates that events and data of the Great Depression are inconclusive in favour of any particular cause. Recent research too, that bases its conclusions on more sophisticated analytical and procedural techniques and also consider most of the previous research endeavours, does not reach convincing conclusions. Vector Auto Regressive (VAR) based studies that begin from Sims (1980), and include Burbidge and Harrison (1985), Bordo et al. (1995), Fackler and Parker (1994), and Cecchetti and Karras (1994), hold monetary factors responsible for the chaos. On the other hand, Sims (1998), Coe (2002), Ritschl and Woitek (2002), and Cole and Ohanian (2000) emphasise that real economic factors have played a major role. The literature thus leads us to different causes of economic crises, however, there has been a general inclination towards monetary factors as the primary cause of snowballing a moderate recession into a great depression (Evans et al., 2004; Hamilton, 1987). These myopic views indicate a 'synthetic' solution and therefore necessitate further digging to reach the root cause of the problem and a need to move towards a consensus regarding the causes of the Great Depression (Eichengreen, 2002 and 2004), so that a concrete foundation is laid for the efficient and smooth functioning of our financial systems, not only capable of eliminating future financial crises but also safeguarding our environment. It is high time to instigate investigation of the issue from a more novel angle with a clear focus on *alternate* approaches.

The literature also sheds light on the role of commercial banks in staging or precipitating a crisis situation. The smooth or otherwise functioning of commercial banks is a fundamental determinant of the cost of capital for borrowers and, hence, has a significant relationship with the real economy. This argument is based on the fact that collateral and other assets that secure banks' credit portfolios are closely connected with the performance and health of the real economy, just as their quality is to the ethical and prudent decisions made by banks' executives. During economic recessions, when asset prices show falling trends, opportunity costs are less, and liquidation rules are more complicated, the trustees tend to delay release of funds to depositors, thus further deteriorating the situation (Anari et al., 2005). Furthermore, the deposits of failed banks, during a financial crisis, prove to be an impediment in the recovery process and hinder economic growth, as in such situations depositors do not have any access to their funds, which remain idle and are not utilised in the process of economic recovery. The vicious cycle of low demand for goods and services, low production, low employment, low household income, leading again to further decreases in demand, hinders the economic recovery process. When adverse shocks hit the economy, whether real or nominal, they primarily affect the financial position of the household, which lead to changes in the composition of household balance sheets. As a result, consumers adjust their economic behaviour, which in turn leads to a decrease in demand and hence economic contraction (Mishkin, 1978). Kindleberger and Aliber (2011) in their work give an informative account of the various past episodes of financial crises, which are briefly elaborated on below.

The Japanese Financial Crisis

Japanese economic stagnation started in the early 1990s as a result of the Bank of Japan's tightening of monetary policy (see Hoshi and Kashyap, 2004) to cool down the 'overheated' real estate and financial markets. This action proved tantamount to pricking the bubble, which was noticed only when it burst. The downturn in land prices that banks were holding as collateral for their loan portfolio rendered the majority of bank loans non-performing. This downfall, at its beginning, was thought to be the normal cyclical economic slowdown when the economy showed some signs of recovery after the government's stimulus package in 1995. However, when in 1996 the economy again plunged into deep recession, the question concerning the real causes of the slowdown regained scholarly attention.

The banking crisis has also had a role in the long term stagnation of Japan's economy in the 1990s. Many analysts viewed this stagnation as an outcome of the boom-bust cycles which characterised Japan's economy up until the late 1980s, when the land and stock prices tripled through a domestic demand-led boom. Economists saw this stagnation as the result of a decline in investment due to the credit crunch. The fall in the real asset prices negatively affected the consumption patterns of households, besides its impacts on the collateral value of banks that deteriorated their balance sheets. This phenomenon can be interpreted in terms of financing constraints faced by firms resulting from the banks' changed lending behaviour in response to the change in government monetary policy (Motonishi & Yoshikawa, 1999). This situation, coupled with other banking policies, put Japan into the vicious cycle of low consumption, low investment, low output and low growth (Dekle & Kletzer, 2003). Part of the literature puts the blame on lax corporate governance laws; permitting the passing of fake or sometimes false financial statements through the audit system that resulted in loss of public confidence in the financial system as a whole.

Asian Financial Crisis

The involvement of the international community and monetary institutions in already fragile Southeast Asian financial systems caused further destabilisation in the region. Several distinguished economists have expressed their feelings and concerns on the role of the IMF as a source crisis rather than remedy to the region's already worsening financial system. These economists highlight the actions and tactics of the IMF that furthered the crisis when it, in times of need, either delayed or denied help, or offered it on terms and conditions, that could be construed as pro-American capitalist imperialism. These prominent personalities included Jeffrey Sachs, director of the Harvard Institute for International Development, Joseph Stiglitz, former chief economist at the World Bank, and Eisuke Sakakibara, Japan's former Vice Minister. The IMF, through its actions, did nothing but to signal to markets that the future is highly risky, by associating its aid with structural economic reforms in Asian countries, thus sparking further doubts leading to panic in the financial world (Wade, 1998).

Although macroeconomic indicators do have the potential to spark crises, we need to investigate them from the bottom as well as at the individual bank level, as banks at the individual level may also be held responsible for financial crises. In a given crisis situation the fact that certain banks survive while others collapse hints towards individual banks' resilience to adverse shocks. Arena (2008), for instance, investigated the failure of banks across Latin America and Southeast Asia by analysing individual bank level data during periods of banking crises in the 1990s. The study controlled for the macro variables by considering bank level data from the non-crisis countries in the same regions as well, so that it could be determined whether crises were the result of individual banks' weaknesses or otherwise. Data analysis showed that bank level fundamentals were significantly responsible for banking failures. Thus, given the interconnectedness and interdependence of the banking sector's constituents locally and internationally, unethical leadership and management decisions in a single bank could translate into a crisis situation for the country's financial system as a whole.

Subprime Financial Crisis

The subprime financial crisis points more openly to the reckless and unethical decisions taken by banks' leaders, referred to as 'financial hydrogen bombs ... built on personal computers by twenty-six-year-olds with MBA's' (Tett, 2009: 36, cited in Currie et al., 2010; see also Lo Curto-Smith, 2012). The start of financial hardships for US banks was due to their huge investments in super risky Mortgage Backed Securities (MBS), which required banks to secure their loans by a mortgage or a collection of mortgages. Analysis of the pre-crisis time indicates that prices of houses rose dramatically to a record high level (about 86 per cent increase in a period of just six years from 2000 to 2006) (see Lo Curto-Smith, 2012). The result was a decrease in disposable income. Further, due to an increase in the national population real household income decreased. A major reason for the increase in housing prices during this time was the enormous relaxation in banks' credit terms and conditions for individuals, as loans were made by banks even to people with poor credit histories. Then further 'securitisation' of these MBS to make them suitable for different institutional and non-institutional investors through a poorly organised intermediate system resulted in highly

risky residential Collateralised Debt Obligations (CDOs), which are securities that are collateralised by debt obligations such as bonds. These CDOs subsequently reflected in the balance sheets of reputable banks in the US with the decline in CDO's prices due to the defaults of subprime mortgages (Acharya et al., 2009).

Diamond and Rajan (2009) argue that the roots of the US financial crisis go back to previous financial crises, specifically the Asian and Southeast Asian economies, which, as a result of the crisis, became net exporters of financial capital instead of absorbers. Foreign capital flooded to the IT sector in the US and suddenly stopped when the financial 'bubble' burst. The real estate market was another avenue that enticed international investors. Banks' management adapted the system to accommodate this potential market, just to keep pace with the credit expansion trend and continue to report high profits. Before the pre-crisis period, foreign investors could not access the US domestic mortgage market, but systems were tailored to make it fit for foreign investors. Furthermore, MBSs were transformed into CDOs as a trade-off between risk and return. Banks' management should have been aware of the complexity and high risk of these securities, but they opted to become a part of the game to ensure their survival in a stiffly competitive environment. Upon the cessation of house price surges and the start of decline in these prices, foreclosures increased drastically. Most of the MBSs became toxic waste in the balance sheets of reputable investment banks and others, which led to illiquidity and insolvency of these institutions (see Lo Curto-Smith, 2012). Although the Federal Reserve took on these valueless securities for their full balance sheet values, still unprecedented aversion remains in financial markets because of the perceived tug of war between opportunism and fear.

These circumstances have resulted in ongoing financial chaos in a very systematic fashion. The crisis emerged in five distinct stages, namely: the meltdown of the subprime mortgage market; their spill-over into broader credit market; the instigation of a liquidity crisis in organisations such as Northern Rock, Bear Stearns, and Lehman Brothers with counterparty effects on other institutions; the bursting of the commodity price bubble; and the ultimate demise of investment banking in the US (Orlowski, 2008). The current wave of crisis resembles in many aspects the Asian and the Russian Long Term Capital Management (the Russia-LTCM) episode of the 1997-98 financial crisis, but it is evident lessons were not learnt from those crises.

Search for the 'Hole' by the Leaders of Financial Institutions

We argue for a novel approach to dig deep into the root cause(s) of financial crises that could meaningfully contribute to overcoming the shortcomings in existing approaches resorted to so far. One of the reasons that financial crises repeat themselves time and again is that measures taken by governments as well as the focus of most researchers so far have principally been restricted to the determination of *direct* causes and short term 'prevention'. The 'elimination' aspect, through a deeper analysis of the root causes and *indirect* solutions with a longer term efficacy, seems to have been ignored by academics and practitioners. A thorough search for *indirect*, but significant, causes and remedies has not been undertaken so far. This misconception about the real cure has been causing the 'disease' to resurrect again and again. Yet another important fact about the financial crises that has been overlooked in the past is that attention has not been given to the basic

functioning of financial institutions and its potential effects on market forces. Diamond and Rajan (2001: 40), pointing to the significance of a 'balanced/moderate' approach to banks' functioning in ensuring market stability, concluded that banks' capacity to perform their basic functions is:

... inseparable from its potential fragility. In this world, actions that ostensibly make banks more stable – such as higher capital requirements (i.e. lower short term debt) or government complete deposit insurance – could impair their functioning and, paradoxically, end up making them less viable.

The cut-throat competition of today's capitalism causes banks' management to act recklessly and unethically in the pursuit of more business and abandon their safe 'moderate' position. We forward the following proposition for empirical investigation in this connection:

P1: An objective and close monitoring of individual banks' lending operations, particularly in respect of their liquidity and sectoral concentration, by the central bank will contribute to effective management of the 'pre-crisis' situation and thus prevent eventuation of the crisis.

Another significant and widely researched variable, in the realm of value creation that more closely relates to the objectives of this study, is corporate governance. Separation of management from ownership is one of the principal features of contemporary organisations which, due to a variety of reasons, carry the potential of management behaving in their own best interests rather than those of the owners. This eventually leads to the commitment of agency costs to 'monitor' managers and ensure owners' overall welfare. For affairs such as determination of directors' compensation, reviewing of financial statements, and nominating directors for election, non-executive directors are appointed who constitute separate committees for these and similar tasks. Executive directors are appointed to carry out tasks such as designing short- and long-term strategy, making finance and investment decisions, and managing and controlling other corporate functions (Vafeas & Theodorou, 1998). One of the Board's important responsibilities is to make sure that fair and reliable statements about the corporation's state of affairs are prepared periodically and made available to all stakeholders – the only liaison about the corporation's internal facts to the external world. This situation, rooted in the concept of principal-agent conflicts, necessitates the constitution of the 'audit committee' by the Board. Collier (1993) argues that firms use audit committees for the purpose of mitigating agency costs.

This paper makes a case for tackling financial crises through effectively managing the governance-specific aspects of modern corporations' operations. A major portion of the reasons that cause financial crises relates to unethical and reckless decisions made by banks' and large corporations' leadership. Business schools around the world produce these leaders. Ethics and sustainability form an integral part of business schools' curricula, however, as demonstrated by the various episodes of financial crisis highlighted earlier, it has not been reflected in these leaders' routine business decision-making. We argue that a country's education system feeds potential graduates into these business schools. As ethical values are better inculcated into people at an early age, primary and secondary schools curricula need to be adapted to incorporate a stronger stance on ethical values. If fed with potential graduates with an ethics-dominant mind-set, business schools have the resources and training capacity to nurture them further and turn them into dexterous leaders duly guided by ethical values. This would translate into curtailed agency costs for

corporations, and contribute to creating an environment of good governance, with potential positive outcomes for the society as a whole. We put forth the following proposition for empirical research.

P2: Effective and objective management of 'corporate governance'-specific issues in banks and large corporations will help prevent financial crisis.

Theoretical Framework for the Study

The literature has so far overlooked evaluation of the phenomena of financial crises from the perspective of some established theoretical constructs or theorems. An objective and thorough probe into an issue from the perspective of some established theorems helps scholars, practitioners, and policy-makers better understand the root cause(s) of the issue and thus come up with more effective solutions. This study fills this void in the literature, and resorts to two theoretical constructs in understanding the issue at hand – Foucault's (1980) conceptualisation of 'power' and 'governmentality' and DiMaggio and Powell's (1983) institutional theory. Leadership can drive positive or negative social practices depending on the leader's own ethical values and, of course, the magnitude of his/her power and authority. Keeping the 'power' and 'authority' constant between the two categories of leaders, those with an ethical mindset will develop, nurture and institutionalise socially beneficial organisational practices through their routine business decisions, and vice versa. Personal goals still outweigh societal goals when it comes to selecting between the two alternatives. In the context of leadership with power and authority, Foucault (1980: 93) asserts that "... power never ceases its interrogation, its inquisition, its registration of truth: it institutionalises, professionalises and rewards its pursuit".

Employing Foucault's (1980) theoretical conceptualisations of 'power' and 'governmentality' to understand the phenomenon from the perspective of 'ethical' leadership, we argue that leaders are vested in the power of 'knowledge' as well as 'authority' to institutionalise certain practices within business organisations, which eventually spread through to other industry players, as predicted under different pillars of institutional theory (DiMaggio & Powell, 1983; Scott, 1995). Players in the same industry find it safe for their own survival to adopt prevalent industry practices rather than 'stand alone' and be deemed 'isolated' (see Covaleski & Dirsmith, 1988; Meyer & Rowan, 1977; DiMaggio & Powell, 1983), although the magnitude and speed with which industry players adopt, in response to environmental pressure, certain social practices, may differ across organisations, depending on each player's specifics (Erakovic & Wilson, 2005; see also Oliver, 1991; Campanale et al., 2010; Burns & Scapens, 2000). Furthermore, management members' mutual 'power mix', both within the organisation and with the outside world, can exert undue influence to shape their organisation that would serve their personal interests, as opposed to the organisation's or societal interest (Benson, 1977). We argue that ethics-dominated leadership will cause the spread of only good practices through the leaders' business decisions and vice versa. The spread of sub-prime mortgages and other unethical and unprofessional practices, as discussed above, are a clear demonstration of 'bad' leadership. Leaders' decisions, if not driven by ethics and morality, result in sub-optimal practices that eventually become institutionalised, with consequences in the form of financial crises. The 'site' for the development of ethical behaviour needs to be revisited by policy-makers. Collective public benefit occurs as a consequence of individuals' actions for their personal

benefits, as Adam Smith's 'classical economics' philosophy asserts. Ethics fails human's rational choices of 'self-centred' selfish choices, particularly in areas where public or societal benefit or harm is at stake. We put forth the following propositions:

P3: 'Power' and 'governmentality' vested in management must have a corresponding accountability for ensuring institutionalisation of ethical practices in organisations.

P4: Effective and fully independent 'internal audit' in organisations ensures ethical and professional business decisions by the management.

Leadership and Ethics – Early Warning Signs

The corrective actions that follow to address financial crises can be categorised into *direct* and *indirect* categories. While we agree that *direct* remedial actions are technically sound, *indirect* efforts have not been directed to the root causes, and this paper is an attempt to fill this void in the literature. Causes of the crisis that preceded the recent financial chaos were multifaceted. Most of these causes when uncovered lead us to conclude foul play and unethical and reckless decisions on the part of people with 'power' and 'governmentality' were the cause. Just before the crisis erupted, global liquidity soared due to large foreign exchange reserves, positive saving investment balances, and current account surpluses in countries like China. As a result, global interest rates declined, and in 2001 long-term interest rates plunged to 100 or more basis points below the level of the previous decade. These pressures resulted in unprecedented expansion in credit markets and rising asset prices. Further, in countries like the US, the interest rates declined due to a flawed monetary policy stance resulting in bankers' hunt for high yields. 'Innovations' in financial markets in the form of 'securitisation' by mortgage originating banks also proved to be a milestone in pushing the market towards the pending collapse, as this securitisation resulted in lower security and collateral requirements to secure banks' and gave rise to subprime mortgage loans. The risk of default was shifted to large investors, which increased the gap between the bank and the borrower on one hand, and reduced incentives of monitoring loan quality for the lending bank on the other. Monetary policy was loosened due to deflationary fear and its effects on the 'debt-financed' housing market of the early 2000s. This policy continued for too long until it was too late, with all players acting in self-interest making sub-optimal unsustainable business decisions at looming costs to society as a whole. The situation was aggravated by the separation of the central bank's supervisory and monetary functions in the quest for efficiency in the financial system (Barrell & Davis, 2008). The printing of currency without sufficient backup value in the US and some European Union countries clearly hints at unethical practices institutionalised by a leadership vested with, in terms of Foucault's theoretical constructs, 'power' and 'governmentality'.

The issue of global liquidity imbalances, where global investors mostly look for value storage rather than for a pure thirst for profit, was another major contributor to financial distress in the US. One potential difference between developing markets and the US is that the reasons for capital flow into developing markets are mostly speculative while in the US these reasons were purely 'search for safety' based. Investors as a whole thought of US investments as a 'safer' alternative without accounting for the real facts of systematic risk. The late 2000s financial crisis evolved into these

three distinct phases. *First*, the 'good shock' period (early to mid-2000s) characterised by foreign capital inflow mostly from central banks and governments. Since the pursuit was for riskless assets, while prices usually increase for riskier assets, this depicted the non-professional nature of these investors and their 'blind' trust in a 'trustworthy' economy. *Second*, there was a huge increase in demand for leverage in the domestic market because of the foreign capital inflow, which resulted in the complex and risky process of 'securitisation' among financial institutions. *Third*, the 'negative shock' period (period after the mid-2000s), in which global investors blocked the flow of capital into these markets, which eventually ruptured the 'bubble'. Hence, in essence, the lack of professional and competent regulation and supervision played a key role in the development and eventuation of these crises (Caballero & Krishnamurthy, 2009).

Comparison between the 2007-2008 banking crisis and the Barings crises (crisis that struck the Barings Corporation in 1890 and again in 1995) (see Kornert, 2003, for a detailed account of the Barings crises) points to some common features between the two instances, particularly with reference to the corporate governance in the banking sector. In both these instances of crises, banks' management behaved in a riskier fashion on one hand, while supervisors' and regulators' lack of competence and professional integrity was at play on the other. Every crisis provides (or should provide) an opportunity for learning for regulators and supervisors to be fed into future regulations and policies. Barings was involved in investment banking since 1890. It exposed itself to international risks when it made a huge investment (£13.6m) in Argentina's water and drainage sector. The lack of foresight about the economic and political circumstances in Argentina, and a sheer greed for short-term gains on the part of management, resulted in the downfall of the invested capital's collateral value, which instigated grave liquidity problems for Barings. The Bank of England came to the rescue by selling American securities in huge amounts that in turn resulted in bankruptcies for several American banks. Similarly, in 1995, again due to complex organisational structures and poor internal and external controls, one of the executives invested heavily in highly speculative and risky futures securities, resulting in losses for Baring. The case of Northern Rock in the United Kingdom is not dissimilar to that of the US banks (Milne & Wood, 2008). Although measures taken by British Treasury to prevent the loss of confidence on a mass scale averted the crisis, the question about companies' management's professional competency and integrity still remains.

Unprofessional and unethical behaviour was at play at almost all levels in connection with the pre- and post-crisis situations. Objective 'central banking' seemed also to be missing in the management of the pre- and post-crisis situations. 'Lender of the last resort function' of central banks is one of the controversial issues faced by today's regulators. Although its primary purpose is to restore investors' confidence in times of crisis, at times it serves as an 'incentive' for banks' management to embark on ventures with unduly high risk and engage in unethical behaviour, such as investing carelessly and extravagantly (Kornert, 2003), purely to enhance personal performance (Dillard et al., 2011; Hopwood, 1972), at a huge cost to the community. Large audit firms, entrusted with the responsibility of 'watching' and 'monitoring', objectively all aspects of these banks and large corporations, did not play their due role in preventing and effectively managing these crises. Moreover entities entrusted with ensuring 'accountability' of those with 'power' and 'governmentality' did not play a proper role in holding the culprits responsible and accountable for their actions.

The above discussion points to some fundamental economic, social, ethical, and corporate governance issues that need to be addressed. The occurrence of the recent financial crisis has furthered the significance of corporate governance and ethical issues. When giant corporations like Enron and Arthur Andersen in the US collapsed, authorities at home and abroad as well as international donors turned their attention to the need for improvement in corporate governance and adherence to ethical standards (see Dillard et al., 2011; Konishi, 2010). The IMF has since added corporate governance reforms to its agenda in respect of the allocation of funds to countries. Furthermore, the Organisation of Economic Cooperation and Development (OECD) has issued a comprehensive document, *OECD Principals of Corporate Governance*, which is influencing companies across the world. The initiatives have made international rating agencies develop indices for rating corporations on the basis of the corporate governance standards they boast to implement (Khanchel, 2007).

Closely related to the above remedies, in fact a prerequisite to them, is the need to inculcate ethical values into business graduates. Teaching ethics at business schools has not 'worked' so far, and there is a need to rethink the educational model right at the grassroots level, that is, at primary and secondary schools, where mindsets are shaped and subsequently dominate students' personalities throughout their lives. If early schooling could prepare a high quality intake for business schools, the output, with all the grooming at business schools, will be of a far better quality. The objective is to make these future leaders overweigh societal goals to their personal goals and uphold ethical values in all their business decisions. The following proposition sounds logical to pursue in future empirical investigations.

P5: To better inculcate ethical values in future business leaders and ensure ethical decisions on their part, the 'site' for teaching ethics to business graduates must change from 'business schools' to 'primary and secondary schools'.

Whatever have been the causes and whatever remedies have been provided in the literature so far, the root cause points to 'people' and their 'personal ethical standards' in business decisions. Business schools around the world claim to provide education on ethics and sustainability, and there is no denying that. Business schools' curricula do cover this aspect of businesses in detail. However, a question still remains unanswered: if business schools emphasise 'ethics' in their curricula, why then do many of their graduates act in a selfish manner when it comes to their own benefit and/or the benefit of the organisations they represent? Currie et al. (2010: S4) termed this 'thinking for themselves'. There still seems to be an unfilled gap between the 'delivery' and the 'reception' of teachings on 'ethics'. It appears logical to think that business schools teach ethics when it is too late for these potential leaders to change personalities that have already been 'shaped' by early educational institutions: the adage there is no use 'beating the line when the snake has already passed' comes to mind, if anything, that has been said so far about this aspect of 'ethics and business education'. In fact, this is one of the 'unrecognised' agency costs, even greater in significance to other such costs, in that it is concerned with costs not only to owners but to society at large, and thus needs to be addressed comprehensively. As per Collier's (1993) standpoint it should be included in audit committees' responsibilities to monitor this dimension in all large corporations.

Conclusions

The Financial Crisis Enquiry Commission's media release of January 27, 2011 on the causes of the financial crisis has confirmed that failure on the part of the financial regulators, financial firms' "recklessly taking too much" risk, incompetency and lack of understanding of policy-makers about the financial system they were responsible to monitor, as well as "systemic breaches in accountability and ethics at all levels" were to blame for the financial turmoil. This conceptual paper identifies the missing links in two areas: *firstly*, unethical decisions by many of the players in the financial world resulting in the recurrence of financial crises every few years, and their impact on society; *secondly*, the 'gap' in business education curricula, not only from the perspective of graduates' technical skills and capabilities but also their 'values' and 'attitudes' (see, Datar et al., 2011). Wallace (2010) elaborates on the 'technical competency' part in her report.

This article has shown that the financial system today is in dire need of a tailored regulatory environment that could tackle the root cause of the problem without negatively affecting the system's vital role of facilitating economic growth (Acharya et al., 2009). While, the literature does indicate the need for a good overhaul of business schools' curricula (see, for instance, Datar et al., 2011 and Currie et al., 2010), it is not directing research to the indirect but significant causes. This article extends this literature and argues for an amendment to the prevalent regulatory model that governs the functioning of the financial market to include an input from the early education sector. 'Ethics' is an integral part of all business schools' curricula, however, it can be deduced from the discussion above that 'meticulous compliance and adherence to ethical standards' is what seems to be the missing link. It is worth noting, for example, that at the time when Enron collapsed, due to the mismanagement and misuse of power and resources, Jeffery Skilling, a Harvard Business School graduate, was at the helm and there have since been many similar incidents.

Consequently, while business schools do teach ethics and sustainability, we argue that meticulous adherence to ethical standards depends on individuals' own values, inculcated into their personalities during the formative years of their lives. That is, strong ethical values must be inculcated in business leaders early in life, so that they do not succumb to the temptation of short-term material gains at the expense of the wider community. The article posits, therefore, that change is needed at the 'grass root' level – the primary and secondary schools, where students' mindsets are influenced and personalities are developed that dominate the decisions they make later in their lives.

Two parties appear to be major stakeholders and thus should plead the case with policy-makers and lobby relevant government agencies to implement the change in schools' curricula: *first*, business schools whose reputation is at stake, and *second*, owners (shareholders) of large corporations, as unethical decisions by management increase agency costs to them. Financial literacy coupled with ethical values inculcated into the very personalities of business graduates is the main trigger of the changes required to rid the world of 'selfish' and 'reckless' financial decisions. Cortese (2003: 16), an influential environmentalist, argues for a change in education within business schools, and asserts that "... it is the people coming out of the world's best colleges and universities that are leading us down the current unhealthy, inequitable, and unsustainable path...". Jarvis (1999) raises a question on the 'knowledge' universities teach. University education is

not a delivery of 'knowledge' but a delivery of 'information,' which transforms into 'knowledge' only when the human brain works on it. Then, it transforms to a 'legitimate knowledge' only if it proves to have worked successfully for the learners' personal or professional contexts (Jarvis, 1999). We therefore, reiterate that the place to make and shape personalities that dominate people's behaviour and actions throughout their life is at primary and secondary schools – not business schools. We further argue that 'societal interests' and 'adherence to ethical standards' be included as the main ingredients in the 'worked successfully' test Jarvis (1999) advocates, and followed up with policy-makers and relevant government agencies, in command of 'power' and 'governmentality', in Foucault's theoretical notions, for inclusion in their policy documents on school education.

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