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## Risk Taking, Principal Agent Problems and Breakdown of Corporate Social Responsibility (CSR): How to Reestablish Safe-Assets and Capital Funding for Social Security?

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## **Risk Taking, Principal Agent Problems and Breakdown of Corporate Social Responsibility (CSR): How to Reestablish Safe-Assets and Capital Funding for Social Security?**

**JEL Classification:** *D23, G01, G32, M14*

**Keywords:** *Capital funding, corporate social responsibility, financial markets, principal agent problems, risk management*

**Abstract:** *The breakdown of the financial markets in fall 2007 and the following debt crisis in the EU has produced an enormous mistrust in financial products and the monetary system. The paper describes the background of the crisis induced by functional failures in risk management and the multifold principal agent problems existing in the financial market structures. The innovated nontransparent financial products have mixed up different risk weights and puzzled, or even fooled formerly loyal customers. Contemporaneously abundant liquidity on the international financial market accompanied by easy money policies of the Fed in the US and the ECB in the euro zone have depressed the real interest rate to zero or even negative values. Desperate investors are seeking for safe-assets, but their demand remains unsatisfied. Low real interest rates and the consequently lacking compound interest effect in the same time jeopardize private as well as public insurance schemes being dependent on capital funding: the demographic crisis becomes gloomy. Therefore, the managers of the financial markets have to reestablish CSR and to divide the markets into safe-asset areas for the usual clients and “casino” areas for those who*

*like to play with high risks. Only with transparency and risk adequate financial products can the lost commitment be regained.*

## Introduction

The concepts of social responsibility are closely connected with the ethical foundations of single societies. Following the approach of methodological individualism in the philosophy of science, **open societies** are defined as societies with *decentralized democratic decision making* and a *well balanced market system*, which assure a dynamic equilibrium in between the social targets (peace, liberty, welfare and justice) and the social instruments (family, morality, law and market) (see Petersen 1993; 2004, pp. 5-42; Petersen, Müller 1999). In such a society, individual property rights play a decisive role. Individuals act in barter or market transactions and generate individual income, which is partly consumed and saved if the individuals possess a sufficient human capital (e.g. a high vocational education) (see Petersen 2012a, pp. 236-264; 2012b). Savings are accumulated over time and generate equity capital, which can be invested in additional human capital (by further education) or into real capital (e.g. farmland or industrial investments). Capable individuals become entrepreneurs who invest capital they have generated by their own hands work. Beside income from labor, capital income forms another income source, which assures the further existence of the individual person. It should not surprise that such an individual person tries to sustain their equity capital and even to increase it as much as possible– the individual acts in self-responsibility. In a family context, savings and equity capital play a dynamic role because parents (or the ancestors) not only take care of themselves but also of the children and grandchildren (or the successors) in so-called inter-generative responsibility. In more complex modern societies, the reciprocity within the family is extended to the whole society, in which the strong society members take care of the less capable members in implementing income transfers based on altruistic elements developing ideas on social responsibility and solidarity. Hence, individual property rights on equity capital are complemented by social liability, which at least in some countries is even expressed by the constitution.<sup>1</sup>

In complex, democratically steered market societies, beside the citizens, who are the principals in the political as economic spheres, the corporate and the government sectors have to serve the citizens' individual interests. The managers in the private corporations, as well as banks and the public institu-

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<sup>1</sup> See the German „Grundgesetz“ Article 14,2: “Property entails obligations. Its use shall also serve the public good “. The concept of Social Market Economy is closely connected with the common welfare obligation of private property.

tions are agents, being controlled via competition on more or less efficient markets or the voting mechanisms in the political setting. From both sectors, the principals need the best information to evaluate the quality of the agent's performance and to control their actions. If information is asymmetric in favor of the agents and the control intensity not sufficient, principal-agent-problems (PAP) arise, which jeopardize the welfare development in the whole society. Agents start to hide risk and misinform principals, with decision making regarding investment of equity capital and involvement in public affairs becoming highly difficult. Hence, institutional arrangements (regulations) to assure transparency on the economic and political markets are of utmost relevance to prevent agents from exploitation strategies, which are played against principals. If efficient regulations are badly missing, fraud and corruption destroy fairness and justice leading to mistrust in governance in the private and public sector, respectively.

## **The aims, Hypothesis and Methodology**

Based on the contextual setting described in the introduction, the paper aims to mirror the financial crises with the principal-agent theory. It focuses on malfunctioning incentive structures emanating from various market instruments that evolved before the financial crises. In addition, it displays the multiplying effects through the implementation of the Euro on these incentive structures pointing on the build-up of the global financial crises.

The papers' core hypothesis states that a series of principal-agent problems located at decided frictions enabled the financial crises to originate in the USA, and to subsequently gain global reach.

Hereto, it applies an inductive methodology through analyzing empirical crises indicators, such as government debt yields and ECB Target 2 balances. Finally, the paper addresses the required changes for the financial architecture pointing to, respectively, three protective and preemptive elements that are still to be implemented by national governments.

## **Monetary System and the Crisis**

Without doubt, the monetary sector plays an important role in the growth processes in highly developed countries. In real life, there is always a risk involved that the power of one sector might become dominating and even endanger the future development of a well balanced societal system. Hence, as the first step, the role of the monetary system in democratically steered

market economies has to be determined and, as the second step, the causes of the crisis on the financial markets are identified.

*The Fundamental Role of Money, Credit and Banking in Market Economies*

The modern monetary system is a fundamental invention of mankind. The welfare of a society is created in the productive sectors, e.g. the primary (agricultural) and the secondary (industrial) sector. With increasing labor division and specialization, the complexity of a society is strongly increasing so that a highly developed monetary sector (as important part of the tertiary sector) is a basic prerequisite to improve the growth potential of a society. The implementation of a monetary system dramatically reduces the transaction costs of a barter economy and works almost as a “lubricant” for the further development process. There is no doubt about: the financial sector has contributed substantially to the welfare gains in highly developed societies.

But, as usual – there is a reverse side of the coin: A monetary system has to play a supportive role for the economic process because the welfare is predominantly created by the primary and secondary sectors. While in the primary and secondary sector equity capital of the business owner (sole trader or shareholder) is dominating, the financial sector is much more dependent on deposits and borrowed funds: the Basel II Accord demands an equity capital (minimum capital requirement) to secure banks’ solvency, which has to be in between 1.6 and 12.5 %, depending on the individual risks structure. Furthermore, bank capital is difficult to define and highly volatile. Since banks are predominantly working with borrowed capital, issues are involved which have been described by modern institutional economics: the principal-agent-problem and moral hazard.

In a macroeconomic view, in the household sector net savings take place, while usually the business and the government sector are in a debtee position. In other words, the business sector (including banks) operates with more or less borrowed money, while the state is totally dependent on taxpayers’ money. Therefore, in both sectors the hazard exists that the agents (bank managers, politicians and bureaucrats) acting with borrowed capital might act more carelessly than the principals (capital owner or taxpayer) would do with their equity capital themselves. In the case when such behavior becomes dominating, societies are confronted with market and government failure, which jeopardize welfare and future development. Hence, democratically controlled state (and international) regulations for the financial sector (banking and insurance system) are necessary to protect investors and capital owners (principals) against exploitation by the managers of the financial

sector (agents), which in reality often show moral hazard behavior in taking too much risks for the borrowed capital.

*Causes of the Crisis – Too Big to Fail*

A modern and efficient financial sector steered by responsible financial managers acting in the interests of the capital owner, but also for their personal profit, remains an important target of national and international economic policy. The abolishment of capital transaction controls and the globalization process have widened the financial markets, created new financial products and new types of financial institutions, being less or almost not regulated by the national supervisory authorities. Especially in the USA a *shadow banking system* emerged, which tremendously gained in relevance and even started to dominate the classical banking structures. In such an environment “subprime mortgages” (in reality, an irresponsible pyramid game) could be “invented”, which have almost destroyed the monetary system in the 2008 crisis. The exaggerated risk behavior of the US shadow banks, which in the first instance have created high profits, has also infected the behavior of the European banks.

In a short term, perspective even very dubious profits made by extreme risk taking increase the rate of return, which induces rising market capitalization at the stock markets. If conventional banks do not follow, they lose in market capitalization and are endangered by an unfriendly takeover. Therefore, more and more banks had to take increasing risks positions for the survival in a strongly increasing footrace for a better competitive position – finally almost leading to the collapse of the financial system. This process was accompanied by a long lasting policy of cheap money, created in the US by the policy of the Federal Reserve System initiated by Alan Greenspan. In Europe, the euro introduced in 1999 also gave rise to the development that at least in some member states (especially the GIPS states – Greece, Italy, Portugal and Spain) the interest level was dramatically reduced. This resulted in a strongly increased public debt especially after the 2008 crisis, which has led into the 2011 crisis within the euro zone.

The widening of the financial markets has increased the pressures on the banks and insurances to move into business segments, which formerly were in the hands of specialized financial institutions (like investment banks, private equity funds, hedge funds, etc.). Even the German banks, with high reputation, have temporarily lost the interest in their smaller private client segment and concentrated on big firms and investment banking. The short-termed windfall gains induced a process of mergers, which has substantially increased the concentration being a threat to future competition. Similar

processes have taken place all over the world, so that only few big banks remained, which are called “systemic” banks, being too big to fail, because bankruptcy of a single bank would now endanger the existence of the national or supranational financial system. All this has been accompanied by more or less inefficient rating agencies being private firms, which are not adequately regulated neither by the national states nor international organizations. This has led to the outcome that an increasing number of experts and citizens have lost confidence in financial institutions despite of the fact that financial products are predominantly “credence goods”.

### **The Empirical Pictures of the Crisis**

The international capital markets have been characterized by a high and increasing liquidity in last decades, especially after the liberalization as consequence of the fall of the iron curtain. Additionally, the periods of consolidation in the budgets of the US in the Clinton administration and the UK have induced innovations in the financial markets, which have strengthened the leverage effects and enlarged the credit potentials. Increasingly risky financial products, accompanied by the introduction of the new currency in Europe (euro), have led to the financial crisis, in which the exploding public debt in the euro zone has contributed additional risks for a gloomy perspective.

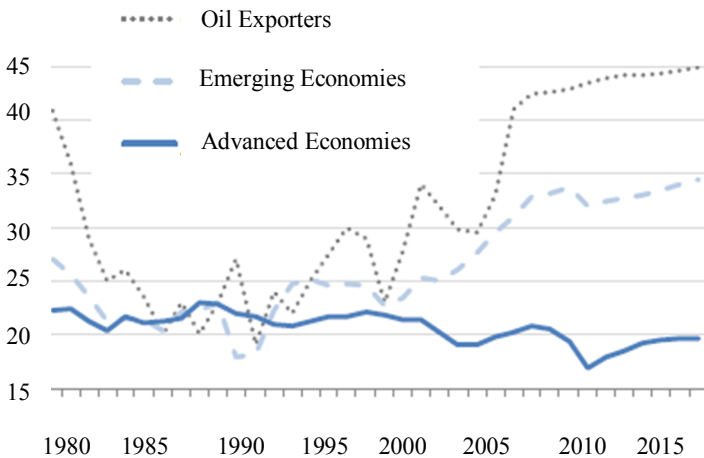
#### *Liquidity and the Crisis on the Financial Markets*

Especially the increasing resource rents in the primary materials producing countries have flooded the international financial markets since the beginning of the 1990's, which have just been almost totally liberated after the 1990 change. Additionally, a long period of strong economic growth was observed in the emerging BRICS (Brazil, Russia, India, China, and South Africa) nations. The countries producing raw material and the emerging ones were not able to absorb all the export surpluses in their own countries, so that especially their governments and/or banks were looking for profitable investments, especially in the highly developed industrial countries. The alternative investment in the really needy developing countries (often being “fragile states”) (For details see Petersen 2010), did not take place because of the supposedly lacking “investment security”, so that their growth remained comparatively moderate.

Figure 1 demonstrates that since the beginnings of the 1990's the saving rates of the oil exporting and emerging economies have been strongly increased, while the saving rates in the advanced economies have more or less been fallen. Figure 2 shows that the decrease of the saving rate has been especially strong in Italy, Japan and the United Kingdom, while the US saving rate also felt to 1 percent in 2005 and only slightly increased after the 2007 collapse.

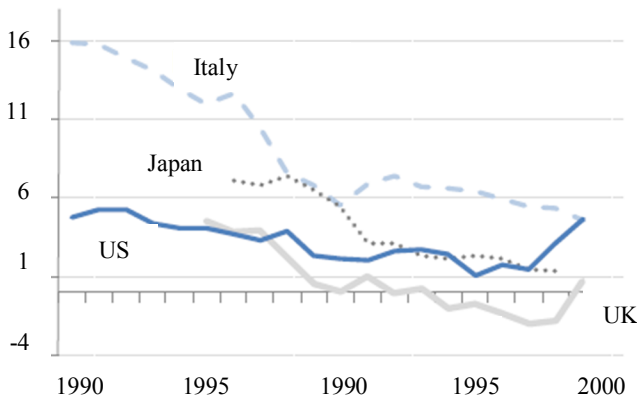
Both figures give clear hints that the excess of saving over the desired investment in the past two decades has been absorbed in the highly developed countries – the US and the member states of the European Union. Here the investment took place predominantly in the new financial products and government bonds. The excess liquidity and the policy of cheap money in the US and Europe has set the questionable incentive to reduce savings in the highly developed countries and to increase their foreign debt.

**Figure 1.** Gross Saving Rate Dynamics as Percentage of GDP



Sources: McKinsey Analytics: McKinsey Global Economic Growth Database: World Development Indicators of the World Bank, McKinsey global Institute (2010).



**Figure 2.** Households Gross Saving Rate in Advanced Economies as Percentage of GDP

Source: OECD (2011).

### *Financial Innovations and High Yielding Bonds*

The low interest policy of the Federal Reserve System (Fed) and the European Central Bank (ECB) consequently caused a strongly decreasing rate of return on government bonds, so that international investors on the global financial markets were searching profitable investment at higher rates of return – neglecting the fact that higher rates of return are only possible when taking higher risk positions. Here the financial innovations came into play. Numerous new financial products were invented to attract the excess supply of capital:

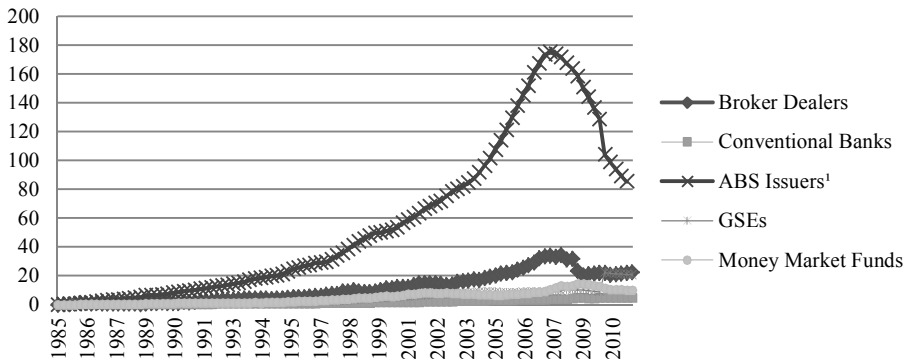
- asset backed securities (ABS),
- collateralized debt obligations (CDO),
- credit default swaps (CDS),
- securitization of different forms of debt,
- derivatives and future markets,
- primary and secondary markets (multiple securitization).

Additionally, new financial institutions have emerged or have strongly gained in influence. Conventional or commercial banking was supplemented by a shadow banking system (non-deposit banks like hedge funds, structured investment vehicles, investment banks, private equity funds, money market funds, insurers etc.), which was outside the national banking regulation and the Basel Accords (Basel I and II) were also not efficient. The financial innovations, as well as the new financial institutions, were permanently becoming more and more complex, so that the information on the real risk

structures of the different investment products was more or less hidden. This was especially true for the multiple securitization, where even experts were not able to evaluate the product quality. This has been demonstrated by the false evaluation of the Rating Agencies (Standard & Poors's, Moody's, Fitch Rating), interestingly being all US private companies. Obviously, there has been no product liability for financial products – neither on the national and nor on the international level, while the product liability for industrial products is highly stringent even on an international basis.

The empirical development in the USA, which generated the financial crisis of 2007/08, is shown in the following Figures 3 and 4. Figure 3 demonstrates that since 1985 the relevance of the shadow banking system (supplying the “financial innovations”) was permanently increasing. The growth of largely unregulated ABS issuers outpaced the growth of regulated conventional bank products; in 2008 the volume of the shadow banking sector reached its peak with about 20 billion USD, compared to the conventional banking sector with about 11 billion USD.

**Figure 3.** Growth of the Securities Emissions in the US-Financial Sectors



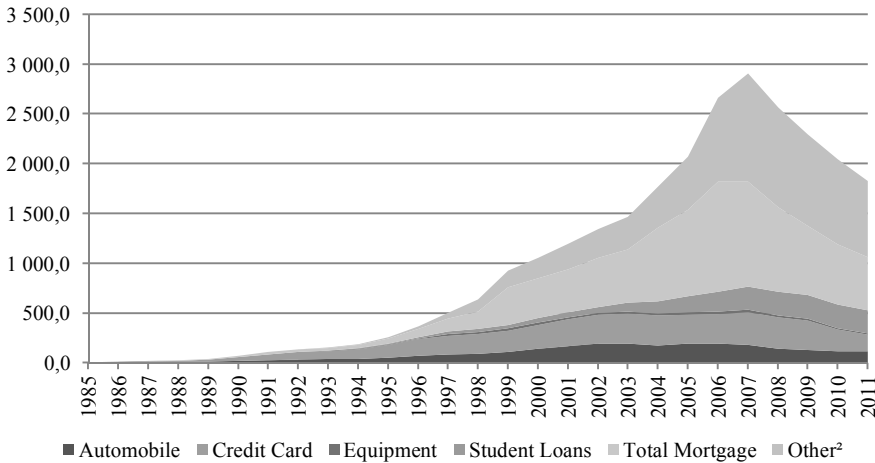
<sup>1</sup> ABS issuers include conduits such as special purpose vehicles.

Source: Federal Reserve Board (2011), Wiegelmann (2013).

The so-called true-sale securitizations are divided into the conventional ABS and collateralized debt obligations (CDO). Conventional ABSs consist of broadly diversified and homogenous credits; its credit worthiness can usually be estimated by actuarial mathematics. However, CDO is an umbrella term for structured bonds, collateralized by much more heterogeneous assets, like credits of private companies partly traded on the stock exchange, illiquid property, real estate credits (collateralized mortgage obligations, CMO), payment requests for automobile loans, credit cards loans, student

loans, consumer credits, public debt titles etc. Additionally, CDOs themselves have been securitized again (re- or even multiple-securitization), so that for the customers the risk structures were usually totally hidden. Figure 4 represents the breakdown of true-value securitizations in the US and its development since 1985. The figure illustrates that the subprime mortgages have permanently won in relevance and the same is true for the CDOs. However, especially highly complex and risky products have dominated the markets for true-sale-securitizations.

**Figure 4.** Breakdown of the US-True-Sale-Securitizations in billion USD



<sup>2</sup> Especially CDOs.

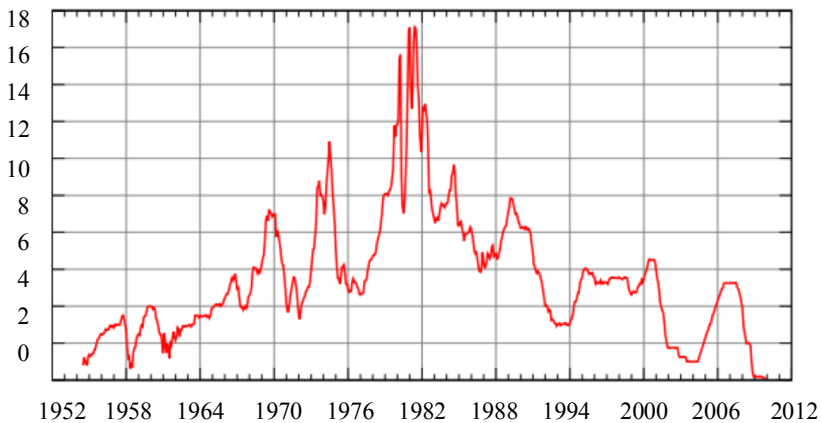
Source: Securities Industry and Financial Markets Association (2011a), Wiegelmann (2013).

Hence, an efficient individual risk management was not any longer possible. At least the higher yield for some of the products was a rough hint that the involved risks were steadily increasing. And all that has happened without any information and warnings for the involved customers. Liability and responsibility considerations have obviously not taken place on side of the product innovators and any product recall – as it is usual for defective products in the industrial and consumption goods sectors – has never happened.

*Euro Implementation, the Crisis of Credits and Exploding Public Debt*

Parallel to that period of product innovations on the financial markets and the US policy of cheap money to overcome the explosion of the dot-com bubble in 2000 (collapse of the “New Market”), the implementation of the European currency zone took place. The policy of cheap money is reflected in the development of the federal funds rate, which is shown in Figure 5.

**Figure 5.** US Federal Funds Rate 1952-2012 in %



Source: Federal Reserve Bank of St. Louis (2012).

Since the beginning of the 1980's, this rate has been strongly decreasing (also reflecting the declining inflation rates) and reached in the crisis years 2007/08 and following almost zero percent.

The crisis of credits arose in several steps:

- The aggressive subprime mortgage policy of the US shadow banking system (including European subsidiary companies, e.g. of Deutsche Bank and many German “Landesbanken”) has led to lower lending standards and high-risk mortgage products (like adjustable rate mortgages).
- The limitation of mortgage liability on housing in the US; there was no jointly and severally liability for individuals like in many European countries.<sup>2</sup>
- Malfunctioning of rating agencies in overlooking the massive problems especially in the shadow banking system.

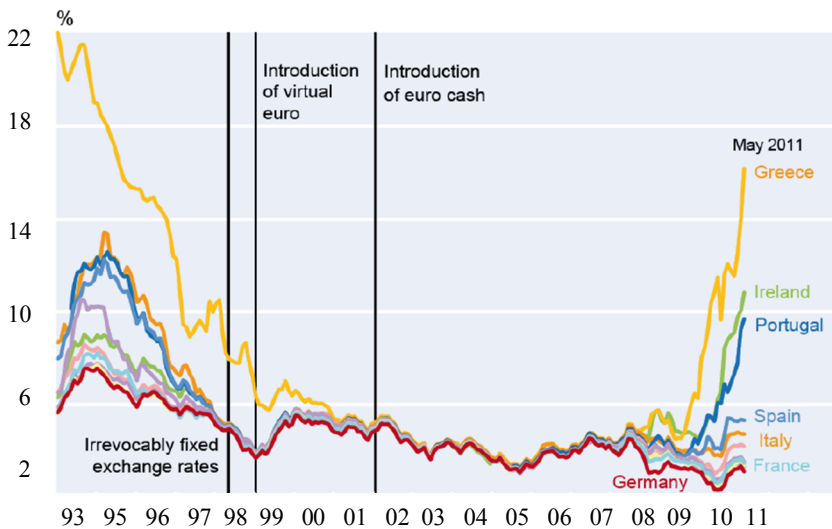
<sup>2</sup> The slogan is: Drop of your keys at the bank and get rid of the liability!

- The real estate bubble (Ponzi or pyramid scheme) as consequence of careless or even irresponsible policies.
- Breakdown of the real estate market and collapse of the shadow (investment) banks.
- Infection of commercial banks and insurances, which have bought junk bonds (especially CDOs).
- Overreaction of the rating agencies in down-grading the government debt titles in the US and Europe.
- Real collapse of economic activities in single countries.
- Decreasing GDP and increasing interest payments on government debt induced enormous budget deficits.
- The enormous increase in refunding needs in some EU member states caused even stronger rising interest rates.
- Single countries came close to bankruptcy (GIIPSC – Greece, Ireland, Italy, Portugal, Spain, and Cyprus).
- Crisis of confidence in the euro system.
- Implementation of financial rescue-parachutes.

Having the development in the euro zone in mind, the implementation of the euro, especially the convergence process before the implementation phase, has reduced the inflation and improved the stability situation in most of the participating member states of the EU. Figure 6 demonstrates that the introduction process of the euro has had an enormous impact on the interest rates in the countries of the euro zone; as an example the net yield of the 10 years government bonds has been chosen. It becomes obvious that the euro implementation has dramatically reduced the interest payments on government bonds especially in the GIIPSC states. In the year of the introduction of the euro cash, 2002, the interest rates of almost all member states of the zone came down to the German level. And the spread in between the interest rates remained very close until the beginning of the crisis in the first half of 2007.

Therefore, the implementation of the euro has led to a strong decrease of the interest structures in all the member countries with the exception of Germany, which has already faced before very moderate interest rates due to the stringent monetary policy of the Deutsche Bundesbank. This decline in national interest payments worked like a business stimulus package, which caused a boom period at least in some member countries, whereas Germany had remained in stagnation until the measures of the Agenda 2010 developed their full positive impacts.

**Figure 6.** Net Yield of 10 Years Government Bonds in Some Member States of the Euro Zone in %



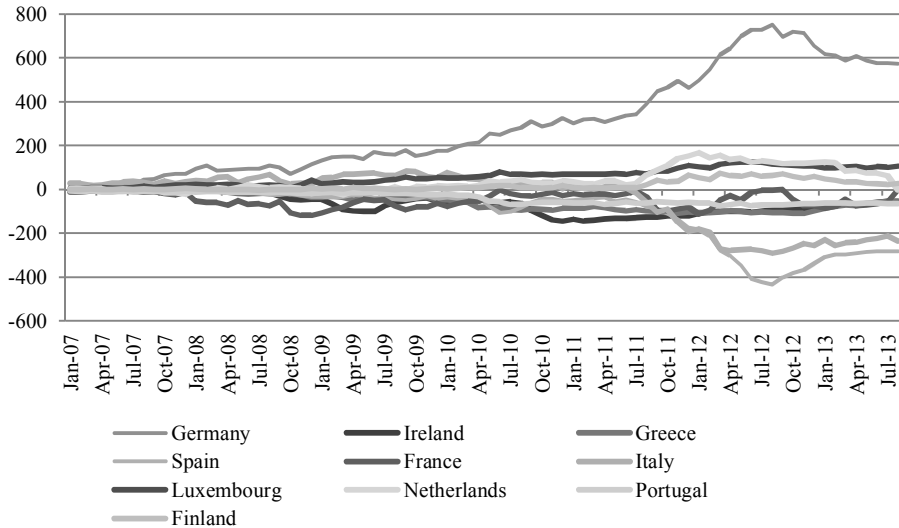
Source: Wikimedia Commons, [http://commons.wikimedia.org/wiki/File:Long-term\\_interest\\_rates\\_\(eurozone\)\\_\(1993-2011\)de.png](http://commons.wikimedia.org/wiki/File:Long-term_interest_rates_(eurozone)_(1993-2011)de.png).

The low interest rates have not only influenced the economic activities in the member countries, but also induced the governments to increase their public debt because of the cheap money, which flooded the international financial markets. The foreign debt dramatically increased, which at least for some period was hidden because of the remaining moderate interest payments in the public budgets. But if the public debt exceeds a level of in between 60 and 80 percent to GDP, increasing interest rates usually cause a dramatic hike in the interest payments, so that exploding budget deficits come to the surface. Hence, these developments induced an increased heterogeneity in the euro zone and the EU. The process of divergence within the economic indicators, especially the internal inflation rates, came into existence.

Since 2007/08, these processes have step by step and much too slowly been internalized by rating agencies, which abruptly changed their policies and simultaneously caused a sudden collapse of trust in the governments abilities to manage such a crisis. The reflection on the international financial markets was an explosion of the risk component in the compound interest rates, which also happened in the euro zone and is depicted in Figure 6, too.

The citizen in the GIIPSC countries increased the consumption levels even more, bought goods and services in the few stable countries in the euro zone (Finland, Germany, Luxembourg, and the Netherlands) and a real exodus of capital from the GIIPSC states to the stable states happened, which is clearly expressed in the so-called target2 balances, which reflect the imbalances in the balances of services and capital movements of the single member states.<sup>3</sup> Figure 7 demonstrates that since summer 2007 the formerly negligible target2 balances have almost exploded and reached their peak level in July/August 2012. Since then, the maximum gap especially between Germany and Spain but also in relation to the other member states of the euro zone is slightly diminishing.

**Figure 7.** TARGET2 Balances of the ECB (billion euro)



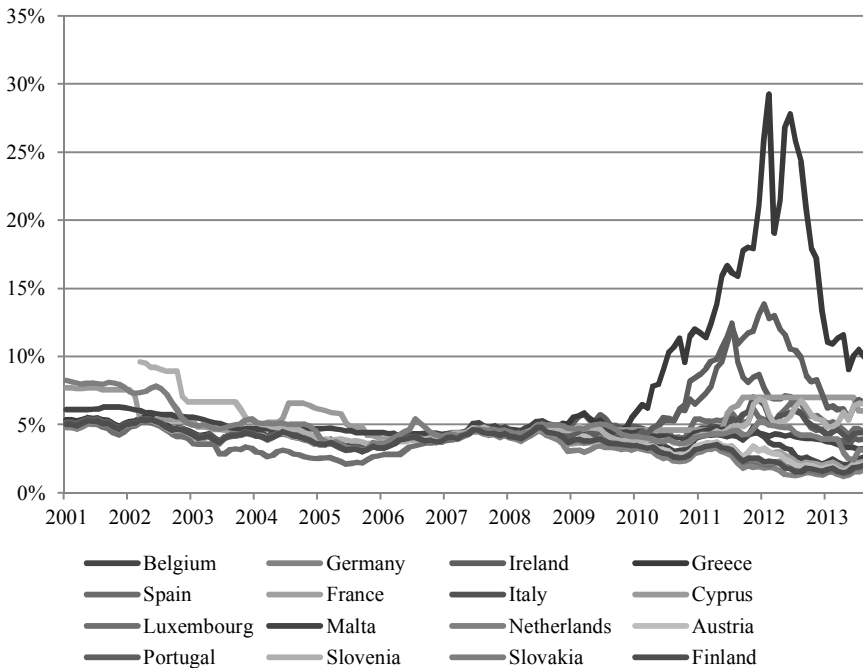
Source: Euro Crisis Monitor, Institute of Empirical Economic Research, Osnabrueck University, <http://www.eurocrisismonitor.com/index.htm>.

The slight reversal trend in the target2 balances since Fall 2012 is also reflected in the development of the governments bonds net yield. The implementation of the European financial rescue-parachutes (Security Market Program SMP of the ECB, European Fiscal Stability Facility EFSF, European Stability Mechanism ESM, European Fiscal Compact EFC, European Financial Stabilisation Mechanism EFSM) have obviously temporarily

<sup>3</sup> For more details on the target2 balances see e.g. Sinn (2012).

calmed down the actors at the international financial markets, so that the long-term interest rates (see Figure 8) were – with some interruptions – also falling since the fall of 2012.

**Figure 8.** Long-term Interest Rates in the Euro Zone



Source: ECB, <http://www.ecb.europa.eu/stats/money/long/html/index.en.html>.

The future will show if the political measures implemented are sufficient or not. Only an economic policy within single member countries which will reduce the public deficits and the interest burden in the budgets seems to be feasible for consolidation and gaining back the trust into the national governments. All the discussions on growth enhancements up to now have been purely rhetorical because nobody has been able to explain how such programs can be financed without endangering the future again – despite the fact that such concrete programs are badly missing.



## **Institutional Economics as Background Explanation**

Economic theory helps to explain what went wrong especially in the last two to three decades in real life. The abovementioned approaches of institutional economics like the principal-agent-problem (PAP) are of utmost relevance as it is demonstrated in the following chapter.

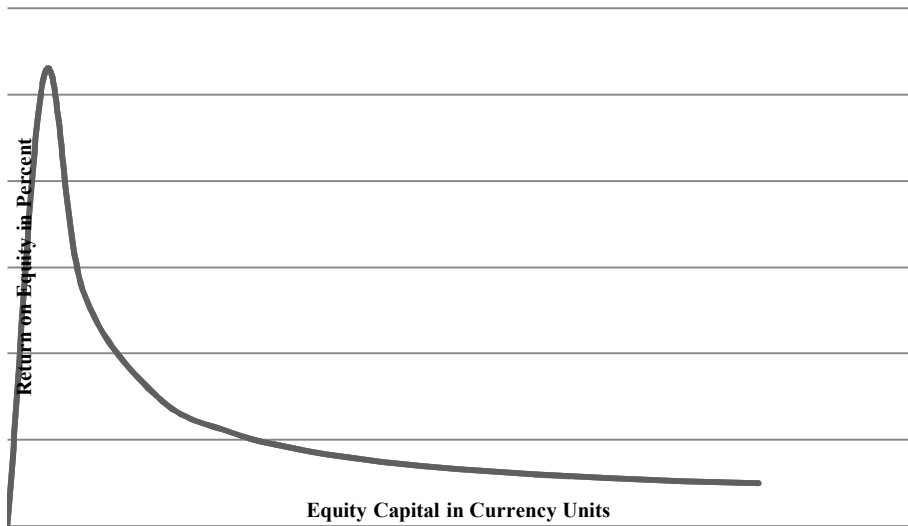
As long as the capital owner her-/himself only relies upon equity capital, principally no PAPs exist. Even if an entrepreneur has limited information (especially on future trends), he/she develops her/his own expectations from experience and forms her/his own management decisions regarding the expected risks. In the simple neoclassical setting she/he tries to maximize her/his profits, assuring or even broadening her/his equity capital basis. She/he is interested in a sustainable development internalizing even voluntarily negative external effects, following the rules of fairness (in a Rawlsian sense) and even assuring inter-generative responsibility in a familial as well as societal context; she/he is acting as a decent tradesman (“*ehrbarer Kaufmann*”), which in the German literature is the basis for the concept of corporate social responsibility (see e.g. Klink 2008, pp. 57-79). This idealized context has to be confronted with the modern economic structures, where sole-traders and small enterprises still exist but borrowed capital and complex organizational structures play a dominating rule. Already the input of the borrowed capital often changes the conditions for responsible behavior, because borrowed capital was formed from the savings of third persons. This alone might have influence on the risk taking attitudes of an investor.

The background for such a behavioral impact is the so-called leverage-effect, which is connected with the input of borrowed capital. Usually the return on equity in a company is higher than the market interest rate (the so-called risk-free interest rate). If an investor can earn an interest rate of 10% with an investment in his own firm and the market interest rate is just 5%, borrowing is rational because the profit is increased by 5% of the investment financed from borrowed capital. If this profit is added to the profit on the equity capital, the return on equity increases from 10% at assumed 100.000 currency units of equity capital and zero borrowed capital to 15% at 50.000 currency units of equity capital, 30% at 20.000 currency units of equity capital to infinite at zero equity capital (see Figure 9). The leverage effect is even boosted, if the excess equity capital can be invested in similar investment projects with the same return on investment. At an equity investment of 10.000 currency units per investment 10 investment projects of 100.000 currency units each can be financed so that the profit increases from 10.000 currency units in case of 100% equity financing to 55.000 currency units in case of 10% equity financing. Therefore, it seems to be rational to employ

borrowed capital, but this employment is connected with substantial risks dependent on the equity/borrowed capital relation.

The entrepreneur is always confronted with the risk that her/his return on equity might not be sustainable, but decrease in the future. In case of employment of borrowed capital an additional risk arises: if the rate of return declines, the borrower cannot any longer service her/his debt (interest payment and amortization of the borrowed capital) . Now it depends on the risk expectations and evaluation of the single entrepreneur if the input of borrowed capital changes her/his attitudes for risk taking. Long term experience and some empirical evidence seem to prove that the input of debt capital increases the willingness to take higher risks especially in case if limitation of liability exists (like in case of limited liability companies and joint stock companies).

**Figure 9.** Equity Capital, Borrowed Capital and Return on Equity



Source: own calculations.

Already the input of borrowed capital combined with limited liability arrangements sets incentives for the investors to take more risks than in the case of full equity financing. If then the intrinsic motivation stemming from ethical paradigms like the “decent tradesman” is buried in oblivion and not any longer communicated as a leading image, the limits for risk taking behavior are more and more eroding.

As long as many economists are of the opinion that moral and ethics are just problems of philosophy and not part of the daily economic life, it is no wonder that critical developments in our societies are coming to the surface and into the consciousness of the people. Since the very beginning of the theory of economic thoughts economists have been fully aware that serious market failures do exist, which have to be overcome by efficient government regulations. But if market failures are not cured and then accompanied by moral failures of the agents acting on the markets (the suppliers and demanders of goods and services),<sup>4</sup> even the whole social and economic system might be jeopardized. Only *efficient government regulations* (“good governance”) and *education in fundamental values* can prevent us from such catastrophes.

Another risk for spreading moral failures is to be seen in the complex economic structures which exist in modern economic systems. The sole trader and the personal entrepreneur relying upon equity capital and self-responsibility are still quite typical in some happy countries having a large small and medium enterprise (SME) sector; but in all highly developed countries big incorporated companies and banks are decisive, having complex organizational structures. For the reason of simplicity in Figure 10 at least some of the complex governance relations are shown.<sup>5</sup>

If the governance decisions are delegated to managers, in terms of modern institutional economics those agents shine up who manage the equity capital of the owner or in case of corporations the shareholders who are the principals in our approach. Principally the managers (or the board of managers or chief executive officers – CEOs) have to act in the interests of the shareholders to maximize the shareholders value. In social market orientated societies like Germany also the stakeholders interest are legally assured (“Mitbestimmungsgesetz” or Co-Determination Act, see Figure 10) to safeguard the common welfare obligation of private property. Then additional agents appear on the scene, representing other than the owner’s interests. And even the management is not only acting in the interest of the shareholders but developing strong own interests, especially interests to maximize their own income and property. In extreme cases, these interests become dominating, so that the equity capital bases of the shareholders may even be destroyed (exploitation of the shareholders by the management). But this is only one PAP, there are many others also involved.

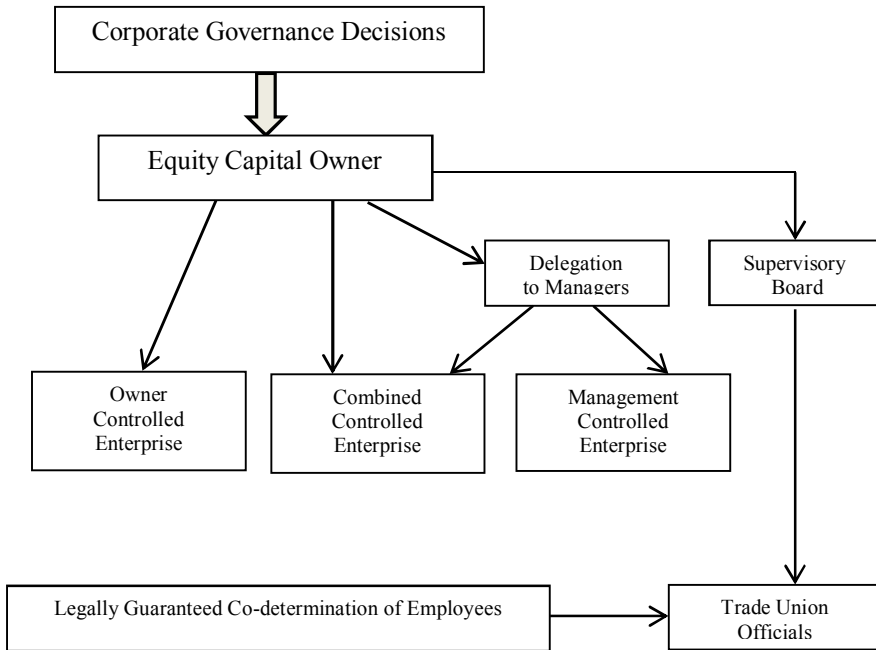
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<sup>4</sup> Markets are just societal instruments like ethics; if the agents (suppliers and/or demanders) on the markets are acting in an immoral sense, the markets outcomes will be immoral, too. For details see Petersen (1993, pp. 128 and 138).

<sup>5</sup> Figure 10 was developed in rough dependence to Wöhe/Döring (2005, p. 71).

Trade union officials, having the main task to represent the interests of the employees (who are the principals in that relation), also develop their own incentives, which might stay in conflict with their clients. For sure, a trade union representative in the supervisory board, or even the board of managers, develops his/her own interest for high remuneration in form of income and property. And in the relation between the supervisory board and the shareholders, as well as the board of managers, experiences exist that numerous PAPs can be involved. Hence, complex governance structures are inevitably connected with multistage PAPs.

**Figure 10.** Corporate Governance Structure in Germany



Source: Based on Wöhe/Döring (2005, p. 71).

A specific example for a collapse of corporate social responsibility can be seen in the above described crisis of the financial markets.<sup>6</sup> As already mentioned above, a modern and efficient financial sector steered by responsible financial managers acting in the interests of the capital owner, but also in

<sup>6</sup> For details see Petersen (2012c).

their personal profit interests remains an important target of national and international economic policy. The abolishment of capital transaction controls and the globalization process have widened the financial markets, created new financial products and emerged new types of financial institutions, being less or almost not regulated by the national supervisory authorities.

Investment traders and bank managers, being all on short-term contracts, have used their temporary mandates predominantly in their own income and property interests and consequently destroyed the clients trust into the banking and insurance system with far reaching consequences for the future development. And all that has happened despite the fact that all these institutions, being private, partly in public-private-partnership (PPP) or totally public, have had ethical guidelines and corporate social responsibility declarations on their internet presentations.<sup>7</sup>

Therefore, complexity has to be reduced, transparency increased and the information systems substantially improved. The managers have to be reminded of the type of a decent tradesman, thus following the obligations of corporate social responsibility again. They have to internalize the traditional knowledge that finance and banking depend on the trust of the clients into the monetary system. Then the principals, the clients of the corporations and the banks as well as the insurances, will regain control over the system and develop again the necessary trust which is inevitable for future growth and welfare. But this recovery has to be accompanied by more efficient public regulation, which has to be implemented even by countries such as the US and UK, where the reluctance against such measures is still much too strong.

## Conclusions

The economic as well as the political system urgently need efficient rules and regulations, which have been exhaustively discussed in the political and economic theory. The necessary technical conditions are more or less obvious today because, for god's sake, we have at least some positive examples in the world. But even in these cases, serious shortcomings still exist, as the world financial crisis since 2007/08 is still evident. The predominantly well-known technical conditions often do not function because the human factor being necessary for an effective implementation and transfer into the practice has serious shortcomings especially regarding the internalized (or not suffi-

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<sup>7</sup> See, e.g., The internet presentation of the Deutsche Bank, <https://www.deutsche-bank.de/csr/index.htm>. That has not prevented the managers of the Deutsche Bank from playing a very questionable role during the subprime mortgage hype in the USA. See the unmasking article in *Der Spiegel*, No. 5, 30.01.2012: "Die Zocker AG – Die dubiosen Geschäfte der Deutschen Bank".

ciently internalized) underlying value system. This is due to the fact that in many discussions technical conditions predominate, while the ethical foundations often remain in ambiguity. Almost every German company has its own CRS guidelines, which sound all quite convincing and are usually to be found on each web page. But this often remains a pure marketing strategy, without consequences to the real actions. The most prominent example is the behavior of the managers of banks and insurances, who must have been fully aware that finance, banking and insurance does only function in the long run when the managers trust each other and also find sufficient trust in the public. The system must collapse if this trust is destroyed. That has not hindered most of them to behave like the lemming just in the pretended self-interest of their personal profit maximizing. For sure, the short-term work contracts have given some questionable negative incentives – but there has also been massive criminal impetus.

If one discusses with the predominantly young financial brokers and traders, it becomes obvious that their motivation is very similar to that which is dominating in another field of daily life – the professional sport. They want to earn in the shortest possible period as much income as possible – most of the leading international soccer clubs are almost bankrupt. The international financial system is not a casino – and the “casino capitalism” (Sinn 2009) as has being executed in the last years destroys the very basis of democratic and market orientated free societies. What is badly needed is a general outcry for a new ethical foundation of politics and economics even in our highly developed countries. If computers and mathematical algorithms substitute the human beings within the financial markets (named electronic trading and banking), not surprisingly social responsibility has become victim of technical progress. But such technical progress destroys the very basis of our societies. We have to reduce complexity and to develop more skepticism against easy, quasi automatic solutions.

The lessons one can learn from the last financial crises are multifold. The financial sector as part of the service sector has developed too strong self-interests expressed in extraordinary rate of returns, salaries and bonuses – the self-interests of the agents are domination the ownership-interests of the principals. Therefore, the role of the financial sector has become more and more relevant, almost displacing not only the owners interest but also the political influence. The financial sector has to be reduced to its classical role in serving the real economy under the regulation of strong national states and international organizations. The agents in the financial sector have to be reminded to a personally binding code of conduct, so that the people’s trust in the financial institutions is safeguarded and not sacrificed for short-term personal advantages.

The concentration process within the financial sector has to be stopped by adequate regulations to secure a sufficient degree of competition in between the different institutions of the banking and insurance sector. The orientation only in the direction of big clients (large enterprises or rich individuals) has to be corrected in favor of the banking and insurance scheme, in which an average citizen is in the focus of financial services. A combination of saving banks, cooperative banks and private banks is of utmost relevance. The old German “house bank” system has been a good example. Private clients and firms have organized their debit and credit relations using such a single bank and the bank managers were perfectly informed about their credit risks being independent from other agents (like the rating agencies). The Basel Accords have partly destroyed this system being of special value for the SME sector. But in the meantime, at least the smaller financial institutions have realized that the return to such a system perhaps leads to a decreasing rate of return, but to more safety in investments and higher customer satisfaction.

Hence, the SME sector needs small and medium-sized banks (SMB) with managers being closely connected to the clients and knowing the individual risk profiles. Multifold securitization bears enormous information losses and the risk of misuse. Multi-agent systems formed by shadow banks and rating agencies are suffering from serious principal-agent-problems, which are difficult to be adequately controlled by governmental regulation. The influence of agents not adequately controlled contributes to speculative bubbles, pyramid and avalanche effects so that the fundamental economic data are not any longer of relevance for the stock markets and the firm’s capitalization. Short-termed speculative interests are then endangering the long term well-being of whole societies. SME, as well as SMB, have to be supported in the development process until they form the backbones of the economy and a fruitful development strategy. Conventional banking methods have to be combined with modern financial products, which have to be characterized by an adequate rate of return and a transparent risk-reward ratio. Also, cooperative credit institutions acting in the interest of the bank clients are a promising approach to limit the influence and the concentration within the globalizing market, which principally creates advantages even for smaller states to get access to the international capital and to overcome situations of national capital shortages. However, the trust or mistrust of citizen and business management into the national governance system is as important as an efficient SMB system.

Last but not least – the European currency system will only survive if the leading politicians in the Euro zone are courageous enough to become emancipated from the US and the UK – both having obviously different interests and concepts on the role of financial markets in their specific economic system. What is badly needed is an own European financial architecture, which

separates the risk profiles into conventional banking, investment banking and high risk areas, in which the super-rich might play in the “casino-style”. What is of utmost importance is the fact that monetary policy returns to a “sound policy”, in which in a mid- and long-term perspective a positive real interest rate of one up to three percent is guaranteed. Only at a positive real interest rate are the necessary saving incentives set for the individuals, which is necessary to overcome the problems of demographic change by partly capital funded insurance schemes. The future of social security in our societies is jeopardized without a strong compound interest effect within the private and public insurance schemes. Therefore, as soon as possible, the ECB has to change its current policy of cheap money.

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