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## The 2008 Global Financial Crisis: Ethic Fail!

### Introduction

Although the 2007–2008 global financial crisis was unique in the way that it exposed the globally interconnected nature of the banking industry, it was not unique in terms of the behaviour of participants, managers, and directors of major corporations. A perfunctory look at some of the scandals dating from the 1980s and 1990s—in both the U.S. and the U.K.—tells us that they prompted repeated calls for a higher standard of ethical behaviour on the one hand, and greater regulation on the other. Many of the scandals regarding Cray Electronics, British and Commonwealth, Atlantic Computers, Ferranti, and Johnson Matthey involved the employment of dubious accounting devices used to enhance profits. There were also allegations that companies had hidden liabilities which auditors failed to spot, causing them to crash within months of being given an unqualified audit report (Cousins et al., 1998; Sikka et al., 2007). In the wake of the collapse of Enron and

Worldcom, the U.S. responded in a prescriptive way by passing the Sarbanes Oxley Act (SOX).

However, worse was to come. Throughout the 1990s and early 2000s, Western banks had been making huge profits (and paying huge bonuses to traders, managers, and directors), through the trading of debt amongst themselves in financial derivatives backed by property values. These Collateralised Debt Obligations (CDOs), or Securitised Investment Vehicles (SIVs) were essentially bundles of loans and mortgages traded at a profit among financial institutions around the world. The selling on of debt freed up more cash to make more loans, and so on. As long as property prices continued to rise, or at least remained stable, all was well. Doubts about the stability of these instruments began to rise in the mid-2000s as more attention focused on the ‘sub-prime’ lending market in the US, which, according to Dooley and Hutchison (2009), by 2007 had lent some \$540 billion. It was the French Bank BNP Paribas that was the first to act, freezing three of its funds, in essence admitting that it was unable to calculate its liabilities (Kingsley, 2012). The consequences are now well-known, with the triggering of a spate of collapses in the U.K., U.S., and Europe, causing bankruptcies in the U.S. (e.g. Lehman Brothers) and massive government bailouts and quasi-nationalisation in the U.K.

Effectively, governments took the view that the banks were ‘too big to fail’. The fall of Lehman Brothers created shock waves, and images of workers leaving their HQ carrying boxes of personal effects added to fears of a worldwide meltdown of financial services, and even national economies. In February 2008 Northern Rock, the U.K. Building Society-turned-bank that boasted of lending up to 120% of a property’s value, became the first U.K. bank in over 150 years to suffer a major run. The U.K. government then went on to announce a £50 billion rescue package, in a move that saw two of the largest banks in the U.K.—Royal Bank of Scotland and Lloyds Group—become part-nationalised. This meant that the government had a say in the

day-to-day operations. In a statement to the House of Commons on 8<sup>th</sup> October 2008, Alistair Darling, the then Chancellor of the Exchequer, explained that the bailout was a move to restore confidence in the country's banking system. Other European nations—notably Iceland, Ireland, and Greece—were put in severe difficulties from which they have not yet fully emerged. Though it is unusual to see national governments step in to save private enterprises from bankruptcy, it was a common perception that economies were reliant on these banks and that governments were left few alternatives but to intervene. Examining the phenomena, Grossman and Woll (2014) question whether the rescue packages were simply a response to the gravity of the crisis or a reaction to fierce lobbying by the banks. They suggest that countries with close, one-to-one relationships between policy makers and banking management tended to develop unbalanced bailout packages. The implication is that large financial institutions had undue influence on policy-makers, and used this power to shape the nature of government intervention.

During the 2008 bailout, the then Shadow Chancellor George Osborne stated in a BBC interview that 'this is the final chapter of the age of irresponsibility and it is absolutely extraordinary that a government has been driven by events to today's announcement' (Sparrow, 2008). Indeed, the day of the bailouts marked a historical and pivotal moment for banking regulation and, in turn, for ethics in banking. It effectively acknowledged that light-touch regulation had failed, that banks were not acting in a suitable way, and were taking inappropriate risks with investor money. Additionally, as if any further evidence was needed, pressure increased on banks to compensate customers who were mis-sold Payment Protection Insurance (PPI) when taking out loans or other financial products. It emerged that banks were earning huge commissions on these PPI products and had put huge pressure on sales staff to add PPI to loans, often without the customer's permission or knowledge. The PPI scandal resulted not only in a court

ordered repayment of customer premiums, but also compensations to those customers affected. In addition, fines totalling £8.4 million were levied by the Financial Services Authority (FSA), fines that at that time were still limited (Mullins, 2013).<sup>1</sup>

Regulation in financial services dramatically increased subsequent to the 2008 financial crisis. There has been a change in regulator as well as a change in the underlying legislation, to allow, amongst other things, the imposition of unlimited fines. The scale of the crisis, and subsequent revelations relating to PPI in the U.K. and convictions for rigging the inter-bank lending rates (LIBOR) caused much soul searching on both sides of the Atlantic. It even prompted Alan Greenspan, Chair of the Federal Reserve from 1987–2006, to state in front of U.S. Congress in 2008:

I made a mistake in presuming that the self-interest of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms ... Those of us who have looked to the self-interest of lending institutions to protect shareholders equity are in a state of shock (Clark and Treanor, 2008).

It seems clear that despite the call for greater regulation, the implementation of new regulations, the creation of new watchdog bodies, and the imposition of increased fines, the blind pursuit of profit and bonus fuelled the conditions that led to corporate scandals and financial malfeasance. In fact, this result was the opposite of what was intended. This article will scrutinise this paradox, and examine what failed in order to cause the ‘perfect storm’ that led to the 2008 global financial crisis. It will argue that the leaders, managers, and employees of financial institutions suffered from one or more of the following: a complete disregard for regulation, a breakdown in human ethics, contempt for customers, or simply a blind pursuit of profit and bonuses. I will argue that increased regulation will not prevent further scandals from happening again. Moreover, this article suggests that increasing regulation actually dissociates staff from ethical decision-making,

and places an almost co-dependent and ultimately unrealistic reliance on compliance and legal departments. Therefore, this article argues that increasing regulation had a direct correlation with the ethical behaviour of staff and management. This, in turn, is setting the industry up to fail again. This article will contribute to our knowledge of financial regulation and the interplay between ethics and the role of regulation and policy-making in general. The article proceeds as follows: in the next section a further exposition of the 2008 financial crisis is outlined to create a firmer context for the propositions made. This is followed by an exploration of the role of the regulator and the notion of ‘compliance’, and a discussion of the paradoxical relationship between ethics and regulation.

## The Global Financial Crisis

The root cause of the global financial crisis, according to Acharya and Richardson (2009), and now almost universally agreed, was the combination of a credit boom and a housing bubble. When the housing bubble burst, it affected not only the housing market but brought the whole economy to its knees. The fundamental cause was that the banks, investment firms, and credit unions were evading capital adequacy requirement regulations, i.e. the banks held inadequate capital reserves to meet any extraordinary calls made upon them. On the one hand, Davies (2010) suggests that the lack of capital in the banking system was down to a weakness in the regulatory framework and a serious accountability gap. Since the crash, the 2000 Financial Services and Markets Act (FSMA) caused the U.K. to move away from the concept of self-regulation and put in place a regulating body that had the power to levy fines, though the question of accountability is still an issue for this author. On the other hand, Barry (2000) puts forward a unique and opposing argument suggesting that most businesses *could* self-regulate, even in the anonymous world of modern financial markets, where people interact

only via a computer screen. In the absence of coercive regulation, a new entrant to the self-regulated market would be inducted into the conventions by existing market players. Barry (2000) even goes on to suggest that most of the spectacular business scandals in the financial services market are the result of over-zealous prosecutors and the myriad of competition-destroying rules.

This argument may have some appeal, but it ignores one crucial point: if the conventions of the existing market players are corrupt, then the idea of self-regulation fails immediately. Self-regulation can surely only work if the ‘rules of the game’ are fair to all, and if there is some sanction for those who choose not to play by them. It seems clear, with 20:20 hindsight, that allowing financial institutions to behave like casinos is untenable. It is equally evident that some of the behaviour by financial market participants was unlawful, and required the attention of zealous prosecutors to fire a warning shot across the whole sector. The changes laid out in the Financial Services Act of 2012 gave the newly created Financial Conduct Authority the power of unlimited regulatory fines. In 2014, these fines came to a total of £1.471 billion,<sup>2</sup> and in 2015, £905 million—these figures reinforce the demand for much-needed accountability of which Davies (2010) speaks.<sup>3</sup> However, it could be easily argued that if the fines are this large then the market is still not operating in line with regulatory requirements, seven years after the crisis. The fact that financial institutions were evading capital adequacy requirements is an important issue in itself. Rules of governing practice have a long history, going back to the Basel Accord of 1988, when the whole issue of credit risk was codified and recommendations were made to banks (known as Basel I). It is pertinent to note, however, that in the U.K. at least, a ‘leverage ratio’ (i.e. some notion of the ratio between debt and capital) was not included at that time—something that has since been amended (Bailey, 2014). Indeed, Bailey goes into considerable detail in his analysis of the failures of Basel I, although the range of factors leading up to

the crash are outside the scope of this article. In essence, the guidelines allowed the banks so much flexibility in the movement of, and reporting of, assets and liabilities, that regulators were unable to control their behaviour.

The banking landscape in the U.K. is a small one and it is, arguably, inherently oligopolistic in nature, with just four major retail banks dominating 75% of the market share (two of those banks are now part-nationalised). This could be a key factor when considering not only the heavy economic reliance on the financial services sector, but also the reasons that the banks were not abiding by the capital adequacy requirements. It could be argued that the leaders of the banks believe that they can get away with anything, because they know that the industry has such a huge sway on the economy. In fact, the Tomlinson Report, commissioned by the U.K. government to review the banks' practices of lending to businesses in distress, concluded that the past reckless behaviour, size, and domination of the two biggest banks left businesses extremely vulnerable. If businesses are vulnerable then it must be fair to state that individuals are even more at risk.

So far, this article has analysed the circumstances leading to the global financial crisis of 2007 and 2008. However, an element of equal importance that runs in parallel is the behaviour of individuals who flouted the regulations, whose greed and personal ambition was placed higher on their list of priorities than their fiduciary responsibilities. Getting around regulations became something of an art form, and actual art forms took on these themes, in films such as *The Wolf of Wall Street* (2013) and *The Big Short* (2015). It also seems clear that a culture developed within financial institutions whereby this behaviour—despite perhaps being against individual companies' codes of ethics, and certainly against the external Corporate Social Responsibility profiles of most of the institutions—was not only tolerated, but positively valued. Indeed, these massive ethical failures on the part of individuals and companies did not stop at the global financial crisis, and since 2008 there have been a number of further high profile



ethical failures within the banking market. These failures include PPI mis-selling, the LIBOR scandal, sanction violations, and the inappropriate nature of sales incentive driven remuneration, which almost certainly directly contributed to the mis-selling problems. In December 2013, Lloyds Bank was issued a final notice and a £35 million fine (a 20% discount was applied) for breaches of Principle 3 (PRIN 3) of the Financial Conduct Authority's 'Principles for Business' related to mis-selling, remuneration, and culture/governance in the retail banks sector between 2010 and 2012 (FCA, 2013).<sup>4</sup> Cited in the notice are practices such as putting staff under intense pressure to sell products that customers did not want, or face demotion and pay cuts. Some of the examples cited are quite shocking: a sales adviser sold financial protection products to himself, his wife, and a colleague in an attempt to avoid being demoted; a 'grand in your hand' scheme for advisers at Halifax and Bank of Scotland made one-off payments of £1,000 for hitting sales targets; and a 'champagne bonus', worth 35% of their monthly salary, was awarded to Lloyds TSB staff for meeting sales targets. With sales staff being so heavily incentivised to simply sell—not to sell ethically to customers who wanted, needed, or could use the product—the house of cards was bound to come crashing down. These examples speak to a culture where, despite driving virtually every economy into recession, few lessons seem to have been heeded, and the drive for profit and bonuses is still the top priority. They paint a damning picture of the leadership of the banks, and the moral compass of their senior management personnel. Perhaps, however, the problem goes further.

Could a phenomenon known as corporate psychopathy explain the lack of ethical behaviour in the financial services industry? Bakan (2004) suggests that corporations displayed many of the symptoms of psychopathy, explaining how cultures developed which take little account of individual rights or aspirations, and where institutional structures lead individuals to adopt modes of behaviour which would be unacceptable in most other social

settings. Boddy (2005) develops this theme and suggests that as far as the individual is concerned, the corporate psychopath is the manager with no conscience who is willing to lie, but able to present a charming façade in order to sell or to gain promotion via a ruthlessly opportunistic and manipulative approach to career development. With financial services being an industry notorious for attracting ruthless individuals, one could argue that such egoism is alive and well in London's financial district and on Wall Street. The ethical decision-making and behaviour of individuals within the banking structure must be questioned; if banks were deliberately avoiding regulatory requirements, then surely the legal, compliance, or leadership team must have known, and yet no one chose to make a stand against this culture.

## The role of legal and compliance departments in the U.K. financial services industry

As more and more regulatory requirements are introduced and increased levels of fines are being levied on the U.K. financial services industry (Freshfields, 2013), the reliance of businesses on both in-house and external legal and regulatory advice is increasing exponentially. The remit of this reliance appears to be growing to incorporate not just legal and regulatory advice but also ethical decision-making. Langevoort (2012) postulates that current literature assumes that law and compliance go hand in hand, so that compliance issues are also under the direction of the General Legal Counsel. This, in turn, suggests that legal and compliance roles position the General Legal Counsel and staff as guardians of corporate integrity—the conscience of the organisation if you will—taking on ethical as well as legal and regulatory responsibilities. Interestingly, Heineman (2007) believes that the choice for general counsel and in-house lawyers is binary: either to represent the interests of the business and risk being legally or ethically compromised,

or to be an inveterate naysayer excluded from core corporate activity. However, whether legal and compliance departments are separate corporate departments or fall under the same leadership, Coffee (2006) suggests that in-house lawyers, whilst well-placed to play a broad guardian role, will ultimately fail as they lack independence and are subject to pressure and reprisals. If this is the case, then it is likely that these restrictions, pressures, and threats of reprisal are influencing decision-making. On the other hand, it may be aiding legal and compliance professionals to become comfortable with a corporate idea or process that they would otherwise be against. It could of course be argued that external counsel is subject to the same amount of pressure, and fear of non-renewal of contracts. The lack of true independence in organisations can be viewed as an example of Weber's loss of freedom, due to the effects of what he called the 'iron cage' of bureaucracy (1930, reprinted 2005).

This raises the question of the role of the legal and compliance department within financial services. If it is to be the conscience of the organisation, then something about the culture within the organisation needs to be included in its remit. It may be that, on reflection, each individual has a responsibility to act within their own ethical parameters to develop an ethical conscience. Indeed, Fisher and Lovell (2009) question whether or not private profit-seeking organisations should behave in a moral and socially responsible way, above and beyond the requirement of the law. The question of 'going beyond compliance' is a basic and enduring issue in the field of corporate responsibility (CR), and Blowfield and Murray (2014) suggest that it lies at the heart of the divergence between rhetoric and reality. That is to say that what companies publish in their CR reports is very often later betrayed by evidence of wrongdoing and malfeasance in practice. In order to bring reality closer to the rhetoric that companies are all too keen to propagate, it seems clear that individuals need to be guided or pressured to behave more thoughtfully. Davies (2001) proposed that it was necessary for

the FSA to link together a number of elements that reinforce one another—to bring the maximum pressure to bear and to move people in a certain ethical direction. These suggestions included the establishment of an ethical framework that went above and beyond the rules, guidance, and support from the FSA, and beyond education and training.

In hindsight, it could be said that these elements moved firms in a certain ethical direction. However, it was not a positive direction: it was a direction that led to legal and compliance departments being relied upon to steer a firm through the regulation whilst maximising profits. This in turn bred a culture of ethics being fused with regulation, and regulation being ‘someone else’s responsibility’. As noted by Coffee (2006), this also invites the question of the impartiality of in-house compliance and legal departments. When the firm is paying their salary and bonus, are these experts focused on profit making? Thus decision-making becomes a risk-based equation: total profit likely to be made versus total fine likely to be incurred. Legal and compliance experts will often use the term ‘getting comfortable’. This describes a process by which they have reached a conclusion that there is not an overt legal or regulatory risk. However, this does not mean that there is no risk. In having to ‘get comfortable’, it is immediately suggested that there is something wrong with what is being decided, and that there needs to be a formalised justification to form the counter argument. Langevoort (2012) proposes that there is an obvious danger here. Physiologically, a large cluster of behavioural traits work to enable people to ‘see what they want to see’, and regard as ‘right’ that which they are motivated to prefer—objective evidence notwithstanding. These traits involve both socio-cultural processes and cognitive ones, and can be intensified within cohesive groups and organisations. As a result, the process of ‘getting comfortable’ may too readily become a process of collective rationalisation, thus leading us to question the objectivity of in-house legal and compliance experts. The alternative is to leave a single person making the decision. Jackman (2004)

suggests that the rules may not be clear enough, and the practitioners may at times need some guidance.

The way in which humans make decisions differs greatly between individuals, and is affected by the current influences upon that decision, the likely outcomes, and if the decision is being made socially or on behalf of an organisation. Focusing solely on organisational decision-making theory, there are several different approaches to understanding this. Social action is representative of sociology, and attempts to view an organisation from the perspective that each individual will have not only their own goals but also their own interpretation of what is being asked of them. In contrast to this is the unitary approach, which sees an organisation as integrated and harmonious, with all individuals working towards the same goal with a shared loyalty. A pluralist perspective will, however, view the organisation as a number of different powerful competing subgroups, all with different agendas, loyalties, objectives, and leaders. It can be argued that the reality of organisations is best understood through a combination of various different theoretical approaches, depending on the CEO and the culture of the organisation.

Organisational decision-making also varies significantly depending on whether the decision is being made by a group or by an individual. A decision can be made by an individual with the appropriate level of power and responsibility, and others are then tasked with justifying that decision after the fact. To some extent that can be seen in the example put forward by Langevoort (2012) of legal professionals 'getting comfortable'. Though many organisations make decisions in a group or often in the form of a more formalised committee, is the adage 'two heads are better than one' always accurate in an organisational setting? Mullins (2013) argues that a disadvantage of groups is the concept of social loafing or the Ringlemann effect. This is a tendency for individuals to expend less effort when working as a member of a group than as an individual, thus forming a negative

synergy:  $2+2=3$ . Between the Ringlemann effect and Coffee's (2006) suggestion that pressure and fear of reprisal dominate decision-making, it could be argued that organisational groups or committees are coerced into making decisions that are only in the interest of the organisation, or worse, the interests of the most wilful character at the table. Mullins (2013) suggests that personal integrity and individual values are important elements in ethical decision-making at work, but this is increasingly supported by a company code of ethics or professional code of conduct. Many financial services firms have implemented such codes—a set of rules which staff must abide by—and often staff have to sign an annual confirmation stating that they have read and understood the rules laid down. However, Matthews (1987) suggests that it cannot be concluded that a code of ethics demonstrates either (1) social responsibility, (2) a corporate culture, or (3) self-regulation. This is a view shared by Stevens (1994) who agrees that there is no clear evidence to suggest that corporations with codes behave more ethically. However, Barchiesi and LaBella (2014) argue that if corporate values or codes are not fully embraced by all management then they are useless, as the actions of management become contradictory to the values. This article argues that organisations need to go back to basics and let individuals make decisions using their own ethical values, instead of trying to implement endless dictated protocols and check lists which effectively prevent staff thinking for themselves.

## Discussion and Conclusion

This article began by positing regulation, designed to reflect increased ethical awareness, as an impediment to that very end. It suggested that the pursuit of profit would always be the major motivating factor in corporate strategy-making and that regulation would be seen as something to accommodate in this pursuit. Equally, it has highlighted a potential conflict

of interest in the relationship between senior company managers and policy-makers, leading to ineffectual or unenforceable regulation.

The financial crisis of 2007–2008 highlighted the unique role that financial institutions have in western democracies. Simply stated, economic growth is required by governments in order to repay debt, and to finance public works and infrastructure. Banks offer credit which fuels demand for the goods and services that create economic growth. However, the means by which lending is managed, and the way in which market participants are rewarded potentially creates a conflict of interest between the pursuit of profit and prudent financial stewardship. The growth in the trading of derivative financial instruments led to valuation issues that were never properly addressed, and this eventually led to the financial crash. Subsequent to the crash and the call for increased regulation, little, it seems, has substantially changed. Scandals continue to make headlines and the position of ethics within financial services remains moot. Boatright (2014) discusses why ethics are needed in financial services over and above legislation and regulation and why the assumption ‘if it’s legal, then it’s morally okay’ is inadequate. Firstly, the law is a rather crude instrument that is not suited for regulating every aspect of financial services, particularly as situations are frequently one-of-a-kind and based on human interaction. It is impossible to legislate every conceivable scenario. Secondly, laws are often created reactively rather than proactively, and therefore it is incorrect to encourage those in financial services to do anything provided it is legal. Thirdly, merely obeying the law is insufficient for managing an organisation or for conducting business, because employees, customers, and other interested parties expect and even demand ethical treatment, and the law is perceived as a minimally acceptable level of conduct.

It can be seen that when financial services are left to self-regulate, priority is placed on profit maximisation and not on ethical conduct. This prioritisation is almost to the detriment of all else. In fact, Curtis (2008)

suggests that poor risks controls, massive leverage, and the 'blind eye' were really symptoms of a much worse disease. The root cause of the financial crisis was the gradual but ultimately complete collapse of ethical behaviour across the financial industry. Once the financial industry became unmoored from its ethical base, financial firms were free to behave in ways that were in their (and especially their top executives') short term interests without any regard for the longer-term impact on the customers, economy, or even the firm's own employees. With in-house legal and compliance departments under pressure to find ways to 'get comfortable' or circumnavigate through the regulation to get the answer the board want to hear, a truly independent view is difficult if not impossible to gain. This is further emphasised by remuneration, and bonus targets and structures. Whistleblowing is rarely seen, despite financial service companies openly advertising that the option is available to staff. Perhaps the financial services firms are not failing to treat customers fairly, or failing to even treat their own staff ethically. However, the fines and notices issued by the FCA reveal a very telling picture; that the financial services industry is riddled with unethical behaviour and is failing in many regulatory areas. While the impact of this continued failure is yet to be determined, there is every chance that a global financial crisis could happen again.



## Notes

<sup>1</sup> FSA Table of fines 2008–2013.

<sup>2</sup> FCA Table of fines 2014.

<sup>3</sup> FCA Table of fines 2015.

<sup>4</sup> <http://www.fca.org.uk/your-fca/documents/final-notice/2013/lloyds-tsb-bank-and-bank-of-scotland> accessed 21st January 2016.

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