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The Ethics of the Financial Crisis[†]

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Der Weltlauf sei—trotz allem—mehr Nichtkrise als Krise*

(Odo Marquard)

I. INTRODUCTION

HISTORICALLY, THE CONCEPT of crisis is closely-related to the evolutionary transformations of the eighteenth century in the United States, Latin America and Europe, namely, to the transition from a stratified form of societal differentiation to the modern primacy of functional differentiation. In contemporary world society, we are not confronting a global change like that, but the concept of crisis is applied to different topics in many fields. While, in the eighteenth century, *the crisis* consisted of a distance between a utopian morality and the present,¹ in the twenty-first century, its main concern becomes the uncertainty and risk of the present.² In other words, the future was a *known land* for utopian thinkers; the problem was a present that could not be adjusted to this normative expectation.

With the rise and worldwide expansion of functional differentiation, it became clear that the built-in resistance to the learning involved in normative expectations was not completely adequate to deal with the increasing complexity and contingency of modern society. Differentiation rejects the moral identity of the entire society. Normative expectations were then either restricted to religion, ideological politics or moral communication, or became more and more abstract—and were even

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* 'The course of the world would—after all —be more non-crisis than crisis' (Author's translation).

¹ R Koselleck, *Kritik und Krise* (Frankfurt aM, Suhrkamp Verlag, 2008).

² N Luhmann, *Die Religion der Gesellschaft* (Frankfurt aM, Suhrkamp Verlag, 2002).

proceduralised—in order to conserve the possibility of a unitary description of society.³ Meanwhile, their prominent place in the organisation of a functionally-differentiated society was taken up by cognitive expectations, particularly in fields such as science, technology, and economy.⁴

The difference between normative and cognitive expectations lies in how disappointments are managed. While the former holds the expectation in view of disappointments, the latter is willing to learn from them and to re-orient the expectation. Cognitive expectations are better adapted to the loss of a consistent and transparent style of behaviour in modern society. Since complexity entails non-linear dynamics of the whole, the cognitive style of expectations can move through the ambiances of uncertainty and risk in a more relaxed way than normative expectations. Instead of reacting against uncertainty, the cognitive style tries something else. Two crucial conditions are needed to accomplish this: there must be a sufficiently-structured social situation that offers contingent possibilities in order to carry out the intended expectation, on the one hand, and no normative de-differentiation of the cognitively-structured social situation must take place, on the other.

In the case of the financial sub-prime crisis, the first condition was accomplished; the absence of the second condition triggered the crisis. The aim of this chapter is to explore the relationship between normative and cognitive expectations with regard to the financial sub-prime crisis. My general thesis is that normative political expectations de-differentiate the cognitively-driven operations of the financial system and over-impose a long-lasting normative conditioning upon autonomously-organised cognitive procedures. The American Dream of an 'affordable home' becomes a foreclosure auction when the cognitive procedures of the financial system can no longer distribute the risks of an on-going housing policy for non-creditworthy clients. Finally, the financial system reacts with illiquidity to the normative political de-differentiation—the game was interrupted and the crisis began.

In order to provide the central steps of this argument, I begin with the Luhmannian, sociological approach to ethics as a reflexive theory of morality. Ethics as reflexive theory is a key theoretical issue to systematise the lessons derived from the financial crisis with regard to the relationship between cognitive and normative expectations for both individuals and systems (Section II). In this framework, highly-fixed normative-expectations tend to over-impose a simplistic *whether-or-not*

³ See, especially, G Teubner, 'Selbstsubversive Gerechtigkeit: Kontingenz- oder Transzendenzformel des Rechts?' in G Teubner (ed), *Nach Jacques Derrida und Niklas Luhmann. Zur (Un-)Möglichkeit einer Gesellschaftstheorie der Gerechtigkeit* (Stuttgart, Lucius & Lucius Verlagsgesellschaft, 2008).

⁴ N Luhmann, 'Die Weltgesellschaft' in N Luhmann, *Soziologische Aufklärung 2. Die Soziologie und der Mensch* (Wiesbaden, Verlag für Sozialwissenschaften, 2005).

model of selection on cognitively-driven social systems whose basic decisional structure relies on a somewhat contingent *either-or* model of selectivity. The unreflexive pressure of the norm upon the complexity and contingency of the world leads to crises (Section III). This can be analysed in the case of the financial crisis by considering, first, the complexly inter-connected cognitive structure to manage the uncertainties, risks and opportunities developed by the financial system (Section IV) and, second, by taking into account how the highly-fixed normative political expectation of an 'affordable home' for non-creditworthy clients triggered a generalised operational illiquidity in the system and caused the sub-prime mortgage crisis (Section V). A first lesson from this problematic setting is that, in spite of complex risk-management structures and multi-layered calculability procedures, the financial system, as a cognitively-driven system, operates always close to the edge, which means that it is beyond any certainty of future events (Section VI). A second lesson deals with the conflictive relationship between normative and cognitive expectations in modern society. By elaborating on Luhmann's approach to ethics as a reflexive theory, I argue that an ethic of contingency may contribute either to a cognitive openness of the norm to the contingency of the world, or to prevent the normativisation of cognitive expectations in cognitively-driven systems (Section VII). Finally, I present some concluding remarks (Section VIII).

II. ETHICS AS REFLEXIVE THEORY

The problem of the relationship between moral norms and the ethical conditions of acceptance or rejection in modern society has been a key analytic issue of moral and political philosophy. Schematically viewed, moral theory has followed three major paths in this regard: the description of what comprises morality, the definition of what is normatively desirable, and the orientation of individuals upon the basis of the precedent dimensions.⁵ Certainly, the concepts of morality and ethics have been subject to semantic transformations. However, alongside this development, different answers regarding these dimensions have come into being.⁶ Nonetheless, the dimensions remain. The rise of sociology opened up a new field for the analysis of the relationship between moral norms and ethics.

There is no question about the novelty and sophistication of the classical and contemporary sociological answers to this matter, particularly in Durkheim, Weber, Parsons, Apel and Habermas. However, I would like to concentrate here on the option that contemporary systems

⁵ See, especially, A Heller, *General Ethics* (Oxford, Basil Blackwell, 1988).

⁶ See, generally, T MacIntyre, *Historia de la ética* (Barcelona, Paidós, 2006).

theory offers regarding the relationship between morality and ethics. In Luhmann's view, ethics as a reflexive theory of morality has a mediatory function, namely, as a societal speaker of morality and also as a translator of societal requirements towards morality.⁷ Reflection, in this case, means establishing a limit to the field of operation of morality, namely, to limiting the expansion of the moral distinction of good/bad as a standard by which the operations of other systems may be judged or decided in terms of esteem or contempt. In this sense, ethics as a reflexive theory, which also functions as a 'speaker of morality and translator of societal requirements towards morality', seems to be more suitable for a cognitive approach to norms when—under conditions of high complexity—a cognitivisation of norms seems to be the best alternative in order to cope with uncertainty and risks.

Cognitivisation of norms does not mean the abolition of normative expectations. It is quite clear in Luhmann's theory that the genesis of normative expectations stems from the evolutionary stabilisation of recursively-selected communications that work as inviolable levels of action at different times and places. Such inviolable levels are called values, and values can move through different systemic communications, because there is no systemically-structured communication form for norms and values: 'one can observe here the take-off of a medium'.⁸ They are a floating communicative style which may be attached to integrative normative expectations and to different societal operations, no matter what particular functions are involved. This constitutes a problem in so far as, in modern society, the symbolic media operate as a functional equivalent to morality: while morality is inclined to integration, symbolic media take specific societal problems into their hands and produce a wide range of differentiated meaningful alternatives to cope with them.⁹ The question now is whether normative expectations can be deemed to be an adequate device to deal with highly-diversified constellations of meaning.

Meaning as described by Luhmann is a sequential production of complexity and risk, namely, complexity—contingency—selection—increase of complexity—risk.¹⁰ Since meaning exceeds what can be

⁷ N Luhmann, *Die Moral der Gesellschaft* (Frankfurt aM, Suhrkamp Verlag, 2008).

⁸ N Luhmann, *Die Gesellschaft der Gesellschaft* (Frankfurt aM, Suhrkamp Verlag, 1997) 340.

⁹ Ibid 317.

¹⁰ See, especially N Luhmann, 'Sinn als Grundbegriff der Soziologie' in J Habermas and N Luhmann (eds), *Theorie der Gesellschaft oder Sozialtechnologie?* (Frankfurt aM, Suhrkamp Verlag, 1971); See, also, N Luhmann, 'Systemtheoretische Argumentationen. Eine Entgegnung mit Jürgen Habermas', in *ibid*; N Luhmann, *Soziale Systeme* (Frankfurt aM, Suhrkamp Verlag, 1987); and N Luhmann, 'Wie lassen sich latente Strukturen beobachten?' in P Watzlawick and P Krieg (eds), *Das Auge des Betrachters—Beiträge zum Konstruktivismus: Festschrift für Heinz von Foerster* (Munich, Piper, 1991).

instantiated through actions and experiences by far, there is an overabundance of meaningful possibilities that remain latent when something is actualised. In this case, the selection adopts the form of complexity. However, meaning entails a second structural form, namely, the *form* of contingency. This suggests that:

The possibilities of further experience and action indicated in the horizon of actual experience are just that—possibilities—and might turn out differently than expected, i.e., that these indications can be deceptive [...] In practice, then, complexity means the necessity of choosing; contingency, the necessity of accepting risks.¹¹

Disappointments may come either from the fact that factual, social or temporal conditions have already changed and that the expectation cannot be fulfilled in the originally planned way, or from the internal conviction that the formerly-desired actualisation is no longer important for the instantiation of individual concerns and personal projects. Whatever they might be, life plans can always be realised in other ways.

Highly-fixed normative expectations cannot deal with this deep-seated contingency of meaning. They become overwhelmed by uncertainties, risks, alternatives and further possibilities. Nationality, identity, cultural authenticity, racial particularisms, religious certainties, political ideologies and sociological utopias are constantly inter-penetrated by massive flows of factual, social and temporal alterities that turn these normative expectations into *real fictions* with vested interests and instrumental-cognitive goals.¹² On the other hand, the knowledge-based complexity of significant functional systems in modern world society—such as the financial system, technical systems, science, economy, law—¹³have developed a robust cognitively-driven structure to cope with risks and uncertainties, and are not willing to accept externally-imposed normative criteria without jeopardising the continuity of their own autopoietic operations.

A cognitivisation of normative expectations means, in this sense, both a cognitive openness of normative expectations to the possibilities of meaning—ie openness to complexity and contingency—and a reflexive limitation of normative expectations into cognitively-driven functional systems. Since ethics as a reflexive theory entails the function of limiting the field of operation of morality, and, therefore, of highly-fixed normative expectations, the ethical reflection becomes a crucial endeavour to keep things apart, particularly in times of crisis.

¹¹ N Luhmann, *Essays on Self-Reference* (New York, Columbia University Press, 1990) 26.

¹² See, especially, A Mascareño, 'La cultura chilena como ficción real' in M Vicuña and M Figueroa (eds), *El Chile del Bicentenario: Aportes para el debate* (Santiago, Universidad Diego Portales, 2008).

¹³ See Ladeur in this volume.

III. CRISIS AND THE NORMALISATION OF COGNITIVE EXPECTATIONS

The semantic polymorphism of the idea of crisis is well illustrated by Koselleck: in Greek linguistic usage (medical, judicial, theological), in its political form in the eighteenth century, in its expansion to the philosophy of history, in everyday life experience, in its economical usage, and in the present understanding.¹⁴ Koselleck argues that the concept was always applied to life-deciding alternatives, namely, to 'answer the questions about what is just or unjust, what contributes to salvation or damnation, what furthers health or brings death', although, in the present, it has been somewhat transformed 'to fit the uncertainties of whatever might be favored at a given moment'.¹⁵ It is precisely in this transformation that the key to understanding the reflexive ethical interpretation of the crisis lies: as long as the concept refers to *whether-or-not* alternatives, the options are not negotiable and become inviolable levels, namely, they adopt the form of values and highly-fixed normative expectations. The crisis moralises, and since morality is a systemically non-differentiated communication form, it can move through different systems and extend the crisis to them.¹⁶ In contrast, as long as the concept of crisis leaves the aspiration of normalisation aside and reflects the uncertainty of whatever might be favoured at any given moment, then the crisis assumes a cognitive style that may ask for new possibilities of dealing with risks. Its main concern becomes the uncertainty of the present, and it assumes the perspective of what I wish to call the cognitive *either-or* model.

While Koselleck understands this as 'vagueness' and 'imprecision',¹⁷ Luhmann moves to a complementary interpretation of crisis:

One can speak about crisis only when a turning point lies ahead in the near future—either for the better or for the worse. However, such a turning point cannot be foreseen [...]. The description as 'crisis' contains an unnecessary dramatization and suggests that a decision would be rendered. Yet, the decisions that are communicated as such do not actually help. One must rather assume that we are dealing with an evolutionary adaptation to the new situation.¹⁸

Luhmann moves a step forward in relation to Koselleck: now, crisis has to do with decisions not yet rendered, which, once rendered, open up further possibilities. In other words, decisions reduce complexity and, in doing so, increase the complexity of social selectivity. A contingent world

¹⁴ R Koselleck, 'Crisis' (2006) 67 *Journal of the History of Ideas*.

¹⁵ *Ibid* 361, 399.

¹⁶ Luhmann, n 7 above, 336.

¹⁷ Koselleck, n 14 above.

¹⁸ Luhmann, n 7 above, 317 and 318.

is a world whose complexity compels us to cognitively-driven decisions (selections) which, in turn, increase the complexity of the world and build systems to compensate for the immanent instability of the process with a cognitive *either-or* model of expectations.

An *either-or* model relies on cognitive expectations. This means that expectations learn from the disappointments triggered by structural constraints, on the one hand, and correct the corresponding behaviour to adapt the expectations to the structural enablements without losing their primary scope, on the other. In contra-distinction, a *whether-or-not* model relies on normative expectations, namely, on the reaction against learning when the expectation confronts disappointments. In the first case (the *either-or* model), a crisis may arise when, at the level of systems and symbolic media, there is no alternative to connect social selectivity and individual motivation—extreme poverty, refugees, migrants in war zones, the politically persecuted, etc. In such cases, individuals are confronted with an over-limitation of the structural limitation of the possible options normally provided by systems and symbolic media, which leads to situations of sub-inclusion.¹⁹ In the case of the *whether-or-not* model, a crisis seems to take place when highly-fixed normative expectations cancel the contingency of both systems and symbolic media, and compel a disruptive normative observation of cognitively-driven operations. This is the case of the financial crisis.

In this framework, a normativisation of cognitively-driven expectations does not provide us the required elements to develop a successful adjustment of individual motivation and social selectivity. Highly-fixed normative expectations cannot observe the contingency of the world. In cognitively-driven functional systems, this function is accomplished through specific structural responses and output, which aim to re-establish the disappointed expectations into alternative possibilities for instantiation. If one persists in the norm, one misses these options, and, in doing so, the system experiences a homogenisation of its communicative style: everybody wants to sell and no one wants to buy.²⁰ According to this, if a normative expectation is unreflexively applied to the cognitively-driven systemic fields, one must anticipate de-differentiation, homogenisation and integration of complexity, and an externally-imposed form of cancellation of contingency. This can only lead to a crisis.

¹⁹ See, especially, M Neves, 'Die Staaten im Zentrum und die Staaten in der Peripherie: Einige Probleme mit Niklas Luhmanns Auffassung von den Staaten der Weltgesellschaft' (2007) 12 *Soziale Systeme*. See, also, N Luhmann, 'Inklusion und Exklusion' in N Luhmann, *Soziologische Aufklärung 6. Die Soziologie und der Mensch* (Wiesbaden, Verlag für Sozialwissenschaften, 2005); and R Stichweh, *Inklusion und Exklusion. Studien zur Gesellschaftstheorie* (Bielefeld, Transcript Verlag, 2005).

²⁰ H Willke, *Smart Governance* (Frankfurt aM, Campus, 2007).

IV. THE COGNITIVE STRUCTURE OF THE FINANCIAL SYSTEM

The financial system aims at the value creation of its own medium money, and must take into consideration the lack of reference points in the environment of the system: there is no factual correlation in the form of necessities or commodities for the financial value creation, as in the case of the real economy. This leads to a highly-dynamic double contingency which cannot be domesticated by rationality principles or efficiency criteria; on the contrary, one must rely on the robustness of the system to carry out selections and cognitively develop 'the capacity to supersede own or someone else's mistakes'.²¹ This entails a developing process of cognitivisation in the style of expectations. The creation of money through money cannot really succeed normatively: whoever holds the expectation of value creation in spite of permanent losses and does not introduce strategic modifications into his or her own operations and selections, is finally excluded from the system through bankruptcy. On the one hand, the cognitivisation of expectations increases the capacity to identify mistakes and, consequently, the capacity to take the necessary measures to correct them in a realistic temporal basis. On the other, it incorporates ignorance (non-knowledge) into the system as a risk to be reflexively managed, in particular by risk management tools.

Factually, the system operates upon the basis of the code risk/opportunities.²² It aims at value creation of the medium money and does not exclude—as a matter of principle—speculative mechanisms, although it finds its own operational limit in the illiquidity. Socially, the system reveals a lack of interaction, which is mainly replaced by a complex technological structure of electronic media and the fragmentation of risks into securities and derivatives. And it is precisely this lack of interaction that pushes normative expectations into the background: individuals do not interact directly with each other, but with highly-determined de-personalisations in which there is no opportunity for the emergence of value commitments. This cognitivises the financial system and produces from the outside morally-loaded attributions of greed and opportunistic behaviour as a critique to the general operation of the system, and also furthers the radical interest in normatively-structured systems for a normative regulation of the financial operations. Finally, in a temporal dimension, the future is permanently introduced into the present as an option of value creation, which allows the system to

²¹ N Luhmann, *Die Wirtschaft der Gesellschaft* (Frankfurt aM, Suhrkamp Verlag, 1999) 122.

²² Willke, n 20 above.

function in the form of anticipation of payments (transactions) or anticipation of anticipation of payments (futures).²³

The management of risks and opportunities, the lack of interaction, as well as the remarkable relevance of 'the future in the present' of the system, are sources of high uncertainty and risk. The most likely option to deal with this is to pay attention to the disappointments of expectations and react quickly to them. In doing this, the system must process its own uncertainty as part of the system thereby avoiding its externalisation in the form of normative criteria such as solidarity or justice. Even trust, which aims to establish a public sustainability of the system in certain political actions, must be neutralised: no financial operation can take the fact that that liquidity could be politically re-established into consideration once illiquidity rules. If this were a generalised expectation, the financial system would not have evolved at all. In fact, the system processes its own uncertainty by transforming its ignorance into risk, and introducing it as information into the system by means of accounting standards, credit ratings and risk management.

Accounting standards allow exchange and comparability of financial data, and provide a generalised description of the financial performance. In some cases, they can act either as regulatory structures—for example, the US Securities and Exchange Commission (SEC)—or as self-constitutional bodies with private self-reflexive structures—such as the Financial Accounting Standards Board (FASB) or the International Accounting Standards Board (IASB). Accounting standards function as assurance mechanisms of the system itself; if they are politically de-differentiated upon the basis of normative expectations, they can no longer reflect the financial performance. They must preserve their cognitive functioning in order to instantiate their sensibility to value variations and risks. Credit ratings, as provided by well-known agencies such as Moody's, Standard and Poor's, and Fitch, cognitivise the risk of investment by classifying the rather opaque issuer's credit-worthiness (and the quality of mortgages) into a standard model through which shareholders may decide to spread risks in bonds and securities. This makes risks comparable, and aims to introduce a future description of a reduced and manageable complexity into the current constellations of decision. In turn, risk management structures—such as the Basel I and Basel II Accords in the banking sector—are concerned with the quantitative and qualitative assessment of market risks in order to provide information to

²³ K Piel, 'Recht als Bestandteil Einer 'Intelligenten' Suprastruktur der Finanzmärkte' in H Willke (ed), *Systemisches Wissensmanagement* (Stuttgart, Lucius and Lucius Verlagsgesellschaft, 1998).

stabilise the highly-volatile expectations of financial markets through the standardisation of risks and self-produced criteria of self-regulation.²⁴

This cognitive quasi-constitutional structure of the system²⁵ has to deal with two immanent systemic risks: moral hazard and illiquidity. Paradoxically, it is moral hazard which represents the amorality of the system. It points out a cognitive risk, namely, the fragmentation of risks into securities, which can, in turn, be regarded as a cognitively adequate strategy to reduce risks. Historically, a bank would lend money and hold the mortgage until its maturity:

If the mortgage holder defaulted, then the bank would usually make a loss. It therefore had an incentive to be careful who it lent to and prospective borrowers would be screened carefully: a sub-prime would-be borrower didn't have much chance of getting a mortgage.²⁶

Nowadays, by securitising the mortgage, the risk of a loss is fragmented in multiple derivative instruments. The incentive is placed on originating the loan and not on holding the mortgage. 'Heads I win, tails you lose' could be the motto;²⁷ or less dramatically expressed, the system develops an 'originate-to-distribute model'.²⁸ Yet, securitisation is a highly efficient cognitive structure to reduce the risk of a single investment by fragmenting it into multiple portfolios and packaging them with other assets of diverse risk value, so that eventual defaults can be absorbed by the robustness of the system. The risk of default remains, because risks are not entirely quantifiable and far from being controllable. However, securitisation creates an environment of risk assessment that fosters the autopoietic dynamic of the system and the expansion of value creation. The cognitive unity of the financial system can, therefore, be observed as the control of moral hazard, acting thus as a sort of contingency formula.

The cognitive structure of the financial system has its operational limit in the illiquidity. While liquidity indicates:

A crowd of willing buyers and sellers who are able to exchange assets without producing a significant disruption, [...] 'illiquid' indicates an absence of both buyers and sellers, and indeed that desperate sellers are likely to be present who are struggling to exchange assets and who are confronted by wide and volatile spreads between the 'bid' and 'ask' prices for the particular assets they hold.²⁹

²⁴ T Strulik, 'Risiko-und Wissensmanagement In Banken' in H Willke (ed), *Systemisches Wissensmanagement*, n 23 above.

²⁵ See Kjaer in this volume.

²⁶ K Dowd, 'Moral Hazard and the Financial Crisis' (2009) 29 *Cato Journal* 143.

²⁷ *Ibid.*

²⁸ D Wigan, 'Credit Risk Transfer and Crunches: Global Finance Victorious or Vanquished?' (2010) 15 *New Political Economy* 111 *et seq.*

²⁹ P Langley, 'The Performance of Liquidity in the Subprime Mortgage Crisis' (2010) 15 *New Political Economy* 77.

Illiquidity is thus part of the system; it must be communicatively processed as risk in order to avoid its presence *in the system* with the aforementioned cognitive mechanisms. This is because, when it comes to operational illiquidity, that is, when assets are not exchangeable at all, it also comes to bankruptcy, to an interruption of the systemic autopoiesis. In plain English: 'A bankruptcy constraint closes the system.'³⁰ Bankruptcy is a temporal interruption of the autopoiesis of the system; it plays a similar role to that of violence for the political system: while violence suspends the communication through power as the symbolic media of the political,³¹ bankruptcy suspends the communication through money in the affected elements of the financial operations. Certainly, bankruptcy can hardly be viewed as a symbiotic mechanism of the financial system. When there is a lack of interaction, there are no bodies to act upon. Nonetheless, bankruptcy symbolises the interruption of satisfaction of necessities in the 'real economy' (a foreclosure auction, for example): thus, the possibility of financial value-creation is closed. On the one hand, bankruptcy breaks up the communication of money liquidity and, on the other, it triggers the external interest for normative criteria to re-stabilise the system in a structural coupling with law and politics.³² In this sense, a generalised operational illiquidity in the financial system can be called a financial crisis.

V. FROM A WHITE PICKET FENCE TO THE FORECLOSURE OF THE AMERICAN DREAM

The question now is what produces a generalised operational illiquidity in the cognitively driven financial system. In my view, the problem arises when, at the level of functional systems, individual normative-expectations are condensed as highly-fixed normative structures *of society* and thus generalised to cognitively-driven fields of communication. A key to the sociological understanding of the financial crisis lies in the fact that normatively-driven political expectations de-differentiate the cognitively-driven field of the financial system and over-impose a normative structure upon autonomously-organised cognitive procedures. In other words, the normative political-expectation of an 'affordable home' or a 'white picket fence'—a key issue in the semantics of property ownership of the *American Dream*—became a 'sub-prime crisis' in the cognitively driven financial system and led to the 'foreclosure of the American dream' at the level of individuals. And when the crisis knocked at every sub-prime door and every prime penthouse, politicians

³⁰ B Yandle, 'Lost Trust. The Real Cause of the Financial Meltdown' (2010) 14 *The Independent Review* 351.

³¹ N Luhmann, *Die Politik der Gesellschaft* (Frankfurt aM, Suhrkamp Verlag, 2000).

³² See Renner in this volume.

turned out to speak of the opportunistic behaviour and greed of Wall Street, and of the need for a new normative regulation of the financial system, ie for a normativisation of the immanent contingency of the cognitively-driven financial operations.

There is no doubt about the fact that miscalculations played a role in the financial crisis, but this is a situation to be expected in complex systems where ignorance (non-knowledge) is incorporated in the system as risk. In fact, complex systems are not fully-calculable because highly contingent events that chaotically amplify their consequences through the interconnectedness of their inbuilt networks constantly emerge. This is the reason why cognitive expectations react better than normative ones to contingent events: they can adapt themselves to new facts and learn from errors. Certainly, mistakes may help to explain why particular firms fell out of the system into bankruptcy, but the illiquidity of the whole system (its autopoietic collapse) must be identified in the couplings with other systems, namely, in policy distortions that led to the generalised financial instability: credit expansion and subsidies to risky mortgages.³³

The core of the problem lies in what Leonard Seabrooke has called the *welfare trade-off*:

Where citizens choose to favor state-based welfare and are happy to rent and receive better welfare services, or where citizens choose lower taxes in return for a better increased opportunity to accumulate individual or familial wealth.³⁴

From the days of the Great Depression, the US Housing Policy has followed the latter. Some of the institutional outcomes of these policies (such as credit expansion and subsidies) can be schematically described as follows:³⁵

- 1934—The creation of The Federal Housing Administration (FHA) to insure mortgage loans.
- 1938—The creation of The Federal National Mortgage Association (Fannie Mae). Fannie was divided in 1968 to create Ginnie Mae which was oriented to low-income and minority borrowers. Fannie Mae became a government-sponsored private corporation to expand the access to a line of credit through the US Treasury.
- 1970—The creation of the Federal Home Mortgage Corporation (Freddie Mac) with analogous functions to Fannie Mae but for Savings and Loans institutions.

³³ L White, 'How Did We Get into This Financial Mess?' (2008) Cato Institute Briefing Papers, number 110.

³⁴ L Seabrooke, 'What do I Get? The Everyday Politics of Expectations and the Subprime Crisis' (2010) 15 *New Political Economy* 56.

³⁵ See, for example, P Boettke, 'What Happened to "Efficient Markets"?' (2010) 14 *The Independent Review*; and Yandle, n 30 above; White, n 33 above; and Seabrooke, n 34 above.

- 1970—The Emergency Home Finance Act allowed Fannie Mae and Freddie Mac to compete in private market (Ginnie Mae in public market).
- 1977—The Community Re-investment Act—Congress-amended in 1995—promoted partnerships between banks and community groups to lend money to low-income borrowers formerly considered non-creditworthy.
- 1993 The pressure on lenders by the Department of Housing and Urban Development (HUD) to relax down-payments and income qualifications.
- 1996—The HUD designs a plan for Fannie Mae and Freddie Mac: 42 per cent of mortgage to borrowers under the middle level; 50 per cent in 2000 and 52 per cent in 2002.
- 1997—The Clinton Administration furthers Fannie Mae and Freddie Mac to buy poor-quality mortgages.
- 2003—The Bush Administration passes the American Dream Down-payment Act, thereby reducing thus the costs required to qualify for a mortgage.
- 2006—The Federal Reserve System reduced the federal funds rate under the inflation rate—borrowers began to gain in proportion to what they borrowed.

One cannot expect that all these policies, which instantiate highly-fixed and normatively-based political expectations acting upon financial operations, have no effect on the cognitively-driven financial system. First, the hydraulic normative pressure on lenders bring them to extend credit—by relaxing the down-payments and the income qualifications—to those which, from a cognitively driven point of view, were previously considered to be non-creditworthy clients (the sub-prime). Second, because the cognitive structures of the financial system react cognitively to new events—that is, because they learn from the world—they deal with these normative political-expectations through the cognitive means which they have at their disposition: accounting standards, credit ratings, securitisation, derivatives, risk management—all of them oriented to control moral hazard and to avoid illiquidity. Third, because these cognitive financial means are able to learn from and adapt themselves to the world, they aim to cognitivise the uncertainties which the external normative-expectations produce in the system by transforming them into a cognitively-contingent model of risk which, on the other hand, never provided certainties or necessities (the *whether-or-not* model), but only future-contingent possibilities (the *either-or* model). Fourth, because the highly-fixed and normatively-based political expectations observe this contingent model of risk normatively, they expect no major alterations in the financial system when reacting to pressures; they

expect normative stabilities and not contingent possibilities.³⁶ And fifth, as the financial system reacts cognitively by producing illiquidity in order to stop the de-differentiation pressures, the political semantics of 'greed', 'opportunistic behaviour', 'social irresponsibility', 'seriously delinquent' and 'kamikaze manner'³⁷ came into play to debase the cognitive-functioning of the financial system as a whole, and to pave the way for *innovative* normative regulations, *creative* political de-differentiations and *original* policy distortions.

Because the financial system operates globally,³⁸ the US housing bubble had supranational consequences. Such highly-fixed normative pressures are hardly manageable for cognitively-driven systems because they must accept the form of the norm and make an effort to translate it into cognitive criteria. The norm then becomes fragmented into alternative possibilities. The political normative-expectation of a 'white picket fence' or at least an 'affordable home' for the 'sub-prime electors' then became partitioned into financial strategies which aimed to manage the financial risk implicit in the norm. This cognitively-driven financial process has been meticulously described by D Wigan:

It starts with a high yielding mortgage sold by broker A to a US customer in a rising housing market and with a two-year 'teaser' rate. Broker A sells the debt to Bank B. Bank B sell this to investment Bank C, which pools it with other mortgages in a Residential Mortgage Backed Security (RMBS). The RMBS in turn is placed in a, possibly hybrid, tranching CDO [Collateralized Debt Obligation]. The equity, mezzanine and senior tranches are sold to investors with varying risk appetites and mandates. A further layer of exposures is created by writing CDS [Credit Default Swaps] on the lower two tranches of the CDO. Here the process becomes synthetic and these CDS can be written by any number of market participants (any number of times) since no 'real' exposure of the underlying is required to write a derivative. Bank D then buys, for instance, 100 such CDS and amalgamates them in a further CDO. Bank E pays cash to buy this CDO, rendering it a 'funded' CDO. Bank F pays a fee for exposure to the payment associated with the CDO's performance, rendering it 'unfunded'. This is a synthetic CDO written on CDS, written on a cash flow CDO, written on a RMBS, written on a mortgage. Hedge fund G then buys ten such synthetic CDOs and re-engineers their tranches to create 30 further distinct synthetic CDOs. The spaghetti thickens.³⁹

Thus, the spaghetti thickens globally, and globally also gives us the certainty that the state has saved us all from the total collapse of the financial system. Yet, what begins normatively can only be finished and

³⁶ See Teubner in this volume.

³⁷ J Brassett, L Rethel and M Watson, 'The Political Economy of the Subprime Crisis: The Economics, Politics and Ethics of Response' (2010) 15 *New Political Economy* 2.

³⁸ G Thompson, "Financial Globalisation" and the "Crisis": A Critical Assessment and "What is to be Done"?' (2010) 15 *New Political Economy*.

³⁹ Wigan, n 28 above, 118–19.

re-started again normatively. The supranational fragmentation of the US housing bubble and the final reaction of the financial system when actualising the reflexive value 'illiquidity' was the only cognitive strategy to cope with the risk of normative policies and the pressures of de-differentiation coming from the political system upon the financial structures. Illiquidity is, in this sense, a sort of *last warning* on the part of the financial operations to stop the game for a while and start the cognition over again. Politics can only observe this normatively by speaking of the 'greed of Wall Street' and other semantic related issues such as the construction of 'moral panic' that the crisis triggers on the public, and whose function lies in hiding its own political role in the problem, on the one hand, and in performing a positive public-setting for a new political normativisation of the post-crisis times, on the other. As stated by T Sinclair:

What is apparent in the moral panic is an initiative to discipline the agencies pursued by a regulatory state, using public shaming as a governance instrument, intent on improving performance [...] Governments need to show that they are taking responsibility.⁴⁰

The normativisation comes back and starts all over again, namely, policy distortions and de-differentiation pressures upon the financial operations, as the political plan to save the Euro zone in 2010 makes clear:

Finally, and perhaps most importantly, the European Central Bank went off and agreed exactly the thing that banks and politicians had been urging it to do, i.e., start buying up government bonds on the financial markets. Where does that leave ECB independence? In a tricky place, not to mention the ECB's central mission to fight inflation, which is in danger of being trumped by political demands from the national governments of the eurozone.⁴¹

However, normative policy-making does not learn from its own mistakes. In other words, 'policy-makers were too attached to the idea that the euro protects against all ills'.⁴² If this is the beginning of a new future world financial crisis, it is still an open question, but it becomes clear that normative policy-making cannot restrain itself from doing what *ought to be done*, and, in doing so, it overwrites the contingency of a cognitively driven financial system.

⁴⁰ T Sinclair, 'Round Up the Usual Suspects: Blame and the Subprime Crisis' (2010) 15 *New Political Economy* 102.

⁴¹ *The Economist*, 'Europe's 750 Billion Euro Bazooka' (2010) available at: www.economist.com/blogs/charlemagne/2010/05/euro_crisis_2?page=3.

⁴² *The Economist*, 'After the Fall' (2010), available at: www.economist.com/business-finance/displaystory.cfm?story_id=16167998&source=hptextfeature.

VI. CLOSE TO THE EDGE

A cognitively driven system is always close to the edge; it is always *at risk*, simply because risk means opportunities. The self-regulating structures of such a social system must deal with risks and not normatively reject them. In so far as a normative rejection of financial opportunities as well as a normative persistence in risky options may lead to a crisis of illiquidity, the system must provide itself with reflexive mechanisms to guide the internal drift of cognitive expectations by stabilising the balance between risk and opportunities. It must manage its own *'either-or'* model. External normative political-expectations only produce instability in this relationship by either normatively rejecting or promoting the (*'whether-or-not'* model) options that the system can only cognitively adjust by producing illiquidity. As a final warning, illiquidity prevents the system from falling into the abyss; it certainly produces a crisis, but the crisis itself becomes an opportunity to re-start the cognitive autopoiesis of liquidity before it is too late.

With regard to the regulatory structures of Basel II, H Willke posits a major change in regulatory matters:

[Basel II] creates a 'supervisory review process' that shifts from control to cooperation, from authoritative controlling to appreciative inquiry, from normative positioning to cognitive reasoning [...] The cognitive turn in supervision follows a deeply seeded and ongoing cognitive turn of the economy in general—from industrial economy to knowledge economy—and of the financial system in particular—from normatively regulated national capital markets to a knowledge-based global superstructure.⁴³

A cognitive turn means, on the one hand, that there is no possible predictability in risk calculations; that greater transparency and harder penalties do not cancel the risk or the contingency of financial operations. It follows from that, on the other hand, that the system must rely on its own reflexive mechanisms to cope with the 'residual uncertainties' of its calculations.

With regard to this, G Thompson argues for de-centralised responses in a model of 'distributed preparedness to resilience', in which regional—and even national—financial structures produce competing regulatory innovations to cope with uncertainties in a bottom-up manner initiating a period of mutual learning.⁴⁴ Central banks seem to have a great deal of significance in this strategy, but—as seen—even a regional central bank such as the ECB can surrender to the pressures of highly-fixed normative expectations. In a more innovative way, J Best argues in favour of a shift

⁴³ Willke, n 20 above, 162.

⁴⁴ Thompson, n 38 above.

from valuation techniques to non-statistical forms of risk assessment.⁴⁵ Stress-testing could be an alternative in this regard—by modelling potential catastrophic events, actors may decide how to respond effectively to them in the present. But, as Best notices, calls for a more sophisticated stress-testing were already made in the 1990s in the wake of the Asian crisis. Ten years later, it has become an issue again.

Be that as it may, in both cases, the immanent contingency of the system cannot be pushed aside. In a bottom-up model of distributed preparedness to resilience, a stronger political influence and complex regime-collisions are expected: safeguards against foreign investments, state protectionism against securitisation, normative-national public order against financial cognitivism, national structures against supra-national orders.⁴⁶ Stress-testing or more qualitative assessments, on their part, may reflect contingency in a more complex way, but they cannot establish future ‘necessities’ or ‘impossibilities’, precisely because contingency rejects both values and has no major problem with living *close to the edge*. What is needed is a quantum leap ‘from a world in which uncertainties are ultimately resolvable into carefully calculated risks into one in which ambiguity, interpretation and inter-subjectivity are recognised as inescapable’.⁴⁷

VII. THE ETHICS OF CONTINGENCY: THE COGNITIVISATION OF NORMATIVE EXPECTATIONS

Such a quantum leap calls for a novel interpretation of the relationship between normative and cognitive expectations. In a contingent world, normative expectations do not provide for any natural certainty in upcoming events. This is the reason why morality and religion have lost their central position in modern society, and it is also the reason why a political system has a conflictive relationship with other systems: it is hard for the political system to harmonise the production of normative world-views with the required learning-capacity to know how, when, and to what extent, goals must be altered, delayed or even discarded in order to protect the norm from dramatic disappointments. This is precisely what *did not* happen with the highly-fixed normative expectation of a ‘white picket fence’.

⁴⁵ J Best, ‘The Limits of Financial Risk Management: Or What We Didn’t Learn from the Asian Crisis’ (2010) 15 *New Political Economy*.

⁴⁶ See, especially, A Fischer-Lescano and G Teubner, *Regime-Kollisionen* (Frankfurt aM, Suhrkamp Verlag, 2006), and also PF Kjaer, ‘Three-Dimensional Conflict of Laws in Europe’ (2009) *Zentrum für Europäische Rechtspolitik, ZERP-Diskussionspapier 2*.

⁴⁷ Best, n 45 above, 42.

In contrast, systems such as science, technology, and the economy do not have this problem:

[they] are currently based on a distinctively cognitive style of expectations.⁴⁸

Since disappointments in these contexts are well-structured social situations, individuals can build up new expectations to protect their primary concerns both rapidly and safely—they may, for example, transfer the mortgage when it becomes a burden for the normative expectation of a better quality of life. But this is not possible when a persistent normativisation of a cognitive system takes place, as the case of the sub-prime mortgage crisis has shown. In dealing with a cognitive style of expectations, normative expectations must be able to learn from the world. This does not mean the abolition of norms, but it proves how important it is to adapt them reflexively in order to keep them in another form.

Thus, ethics as a reflexive theory of morality has a double function: (a) it may contribute to the instantiation of normative expectations by offering alternative possibilities of realisation. This means that a cognitive openness of the norm to the contingency of the world has to be furthered. The primary concern of the norm can be protected by its cognitivisation against devastating disappointments; and (b) it can also prevent the normativisation of cognitive expectations by limiting and regulating the consequences of morality and thus re-establishing the maximalisation of choice proper to cognitively-driven systems. Since moral norms tend to promote future necessities that *must be* factually, socially and temporarily instantiated, or since they aim to establish specific impossibilities which cannot be materialised at all, moral norms cancel the cognition of a contingent world and put themselves into a paradoxical situation: whether one holds the norm in spite of a clearly upcoming dramatic disappointment, or one abandons the norm and allows oneself to be swept away into an anomic situation. In this regard, ethics as a reflexive theory of morality avoids both extremes through a reflexively organised cognitive openness of the norm and the limitation of its pressures upon cognitive structures. Thus, it becomes what I want to call the *ethics of contingency*.

In its philosophical meaning, contingency has adopted many semantic forms.⁴⁹ Applied to sociological and anthropological matters, the world is

⁴⁸ Luhmann, n 4 above, 72.

⁴⁹ See, especially, H Blumenberg, 'Kontingenz' in K Galling (ed), *Die Religion in Geschichte und Gegenwart*, III Band (Tübingen, JCB Mohr, 1959); see, also, F Wetz, 'Die Begriffe 'Zufall' und 'Kontingenz'' in G Graevenitz and O Marquard (eds), *Kontingenz* (Munich, Wilhelm Fink Verlag, 1998); M Makropoulos, 'Modernität als Kontingenzzkultur. Konturen eines Konzepts' in G Graevenitz and O Marquard (eds), *Kontingenz*, this note above; H Lübke, 'Kontingenzerfahrung and Kontingenzbewältigung' in G Graevenitz and O Marquard (eds), *Kontingenz*, this note above; O Marquard, *Apologie des Zufälligen*

contingent in so far as it is neither necessary nor impossible.⁵⁰ Contingency entails thus a double negation: the negation of necessity and the negation of impossibility. It is an *Eigen-value* of modern society;⁵¹ otherwise formulated: it is the inviolable level of modern society.

As an inviolable level of modern society, contingency has an in-built pre-disposition to defend itself from highly-fixed normative expectations. The moral structures of society seem to begin to understand this ultimate truth of functional differentiation as they morally react, in some cases, against a moralisation of systemic codes. In this context, a moralisation of systemic codes would mean:

That the office holder is morally good, the simple citizen is morally bad; having low grades in school makes a morally bad pupil; having no property a bad citizen [...] Criticism in science or arts would turn into a moral battle. We see the temptation, but we also see that our society has to avoid such confusion of moral and other codes. [§] The most remarkable fact is that we would morally object to such a fusion of codes [...]. The moral itself accepts and even postulates this dissociation, this loss of sovereignty, this negative self-restraint as a condition of its autonomy.⁵²

Only a cognitivisation of norms may lead to such negative self-restraint. Nonetheless, in modern society, this is not a generalised standard situation. With regard to the financial crisis, the persistent pressure of normative expectations upon a cognitively-driven systemic setting has seriously affected its own autonomous operation and has even blamed it for the crisis by attributing to it the moral stigma of the 'greed of Wall Street'. In such cases, the ethics of contingency—as reflexive theory—become a kind of immune device of society to preserve the 'either-or' model of a contingent world and keep things apart.

By offering alternatives for a reflexively organised cognitive openness of the norm and preventing a moralisation of systemic codes, the ethics of contingency entail the recognition of an undetermined and multi-layered diversity of partial *Eigen-values* in modern society, and it presupposes also the possibility of their recreation and disappearance. However, it presumes that no recreation of partial *Eigen-values* can take place for the sake of *necessity*, and no disappearance of any of them can be previously justified as an *impossibility*. If these conditions were accomplished, the conflict between *Eigen-values* might be regulated by a cognitive mode of producing coordination that enforces the contingency of the coordinated social constellation. Thus, the ethics of contingency promotes a sort of

(Stuttgart, Reclam, 1986); O Marquard, *Philosophie des Städtischen* (Stuttgart, Reclam, 2000); and O Marquard, *Skepsis in der Moderne* (Stuttgart, Reclam, 2007).

⁵⁰ O Marquard, *Apologie des Zufälligen*, n 49 above; N Luhmann, *Beobachtungen der Moderne* (Opladen, Westdeutscher Verlag, 1992).

⁵¹ Luhmann, *Beobachtungen der Moderne*, n 50 above.

⁵² N Luhmann, 'The Sociology of Moral and Ethics' (1996) 11 *International Sociology* 35.

modus vivendi, whose 'only moral pre-selection said to be ethically permissible is the pre-selection that guarantees the freedom of selection'.⁵³ The rest, we can say, is risk and uncertainty, and the same applies for both systems and individuals. While, in the case of the financial system, the risk is fragmented to create new opportunities by means of cognitively-constructed mechanisms, individuals have to deal with risks through the whole process of instantiation of their personal projects of social inclusion.⁵⁴ These projects are *normative* in the sense that individuals continuously seek for opportunities to instantiate their primary and secondary concerns despite the disappointments that they may confront in specific social situations; in turn, they are *cognitive* because individuals may reflexively adjust their primary and secondary concerns in disappointing social situations by adapting them to the structural enablement and the possibilities of social selectivity offered by symbolic media and functional systems. Personal projects of social inclusion are thus the cognitivised normative-expectations of individuals.

Thus, the normativisation of cognitive expectations entails more necessity and impossibility than an *Eigen-value* can process without becoming unstable as such. To this extent, the ethics of contingency are—on the one hand—a reflexive assessment of the systemic relationships among autopoietic systems which aim to prevent major de-differentiation problems which may certainly lead to a generalised societal crisis, and—on the other—a cognitive form to adapt normative expectations to the possibilities of the world, without losing the primary concerns that guide their individual life plans.

VIII. CONCLUSIONS

The rise of functional differentiation seems to lead to a major shift in the pre-dominant style of expectations in society. While, in segmentary, centre/periphery and stratified societies, the prevalent style of expectations is the normative form, in functionally-differentiated modern societies, cognitive expectations have acquired an increasing significance in diverse systems. Since normative expectations do not disappear from the modern world, but, instead, converge on specialised systems, such as religion and politics, and on specific communication fields, such as morals and values—while other systems, such as science and the economy, adopt a cognitive style of expectations—conflicts that confront normative aspirations with cognitive operations may arise among

⁵³ W Rasch, 'Immanent Systems, Transcendental Temptations, and the Limits of Ethics' (1995) 30 *Cultural Critique* 217.

⁵⁴ See, especially, M Archer, *Realist Social Theory: the Morphogenetic Approach* (Cambridge, Cambridge University Press, 1995); and M Archer, *Structure, Agency and the Internal Conversation* (Cambridge, Cambridge University Press, 2003).

functionally-differentiated systems. The financial sub-prime crisis can be regarded as an example of such conflicts: the highly-fixed and normatively-driven political expectations of an 'affordable home' for low-income clients de-differentiate the cognitive operations of the financial system and over-impose a normative construction upon cognitive procedures. This cancels the contingency of financial operations and triggers illiquidity.

It does not seem to be pointless that the ethics of contingency as a reflexive theory not only warns against the moralisation of systemic codes, but also against a normativisation of the immanent contingency of cognitively-driven operations, and offers alternatives to a reflexively-organised cognitive openness of the norm. This means a reflexive observation and assessment of the problem of normativisation of cognitive expectations, because these de-differentiation pressures cancel the contingency of the world and turn cognitive decision-making into an unfeasible undertaking. In this sense, contingency is not only a key element for the continuity of societal autopoiesis, but also a crucial motive to notify individuals that there is more than one form of instantiation for their life plans. If the ethics of contingency accomplish this, there would be no crises, at least, not for a while.

