

# FINANCE : to be ETHICAL or not to be

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- Ethics and Finance :
  - Aren't these two terms contradictory ?
  - Is there a need of ethics in finance ?
- Examples
  - Enron, Madoff, AIG ...

- 4 main characteristics of the world of finance today
  - Globalization
  - Disintermediation
  - Diversification
  - Deregulation
- And a fifth one  
...greed !

- Globalization :
- Financial entities are present all over the world and have clients all over the world :

- Disintermediation :
- Banks have transferred their traditional risks to other economic agents who have not necessarily the capacity to deal with them

- Diversification :
- A consequence of banks abandoning their traditional activities

- Deregulation :
- Authorities have abandoned partly their responsibility and transfer it to market forces or to self regulation.

- Greed :
  - Bank chiefs' pay rise by 36% in the US and Europe
  - The four New York-based banks will spend a combined \$84.4 billion, or an average of \$141,192 a piece, on their 598,073 workers, according to financial reports released since Jan. 14. more than the GDP of 13 entire countries

- The current crisis is directly a consequence of these evolutions in the financial sector :
  - Globalization of the finance industry
  - Disintermediation
  - Deregulation
  - Greed
  - Role of the regulators
  - Role of the politicians

- Investors and ordinary people have been deeply affected by these shifts in the finance industry

Because of the 2008-20 ? crisis

They have lost their confidence in the prevailing economic model

- Result is frightening :
  - Erosion in trust and confidence in the institutions, in the products and services, and in the individuals involved.
  - Refusal of the economic measures that have to be taken to solve the debt problem
  - Mistrust in the free market and capitalist system

- Can we accept that it should be again :  
“business as usual” in finance today ?
- Does the world of finance should not change?
- What can the actuaries bring in this debate?

- We have to put more ethics into all of this
  
- So we have to propose a solution that would promote ethics in finance :
  - What can be done to better organize the financial sector ?
  
  - What do we to do as actors of the world of finance ?

- Actions have been taken by the governments
  - G8 / G20 meetings
    - On Remunerations
    - On Transparency
    - For more regulation

- Is it sufficient ?
- Partly yes but only partly
  - Rules are necessary but we have to change the behavior of the actors
  - By defining better the role or the economic function of the players
  - By putting more ethics into all of this

- Better definition of the respective role of the players
- Example of the credit system :
  - A commercial bank has two functions : safeguard the money provide credits
  - Cannot play another roles without entering into conflicts of interest or loosing its specificity
  - So they should be a total separation between the commercial activities and the investment banking and trading activities

- Trading and brokerage :
  - Trading for the own account is very specific it is a function that should be left to specialized entities willing to take risks and provide liquidity in the markets
  - Execute a transaction is something very different : you have to deal in the best interest of your client, that is the best execution rule imposed in Europe
  - Clearly there should be a total separation between these two activities to escape conflicts of interest.

- Remuneration
  - The world is more than upset by the enormity of the remunerations and bonuses earned by most of the people in finance
  
  - What can justify such levels ?

- Transparency :
- Some examples : we don't know today what is the real exposure of the European banks on several risky European countries ! And even we don't have these figures for the European central bank
- How the private client could measure the risk he has in depositing its money in a bank ?

- More regulation : or a better regulation !
- Risks : we should think whether risk based capital which is underlying the principles of the financial regulation is really the best approach on risks

- Ethics in finance is an imperious necessity for a well-ordered finance, which will play its fundamental role of feeding the correct resources into the most fruitful projects.

- If finance in its role as mediator substitutes the ends for the means, and becomes its own idol, the ethical dimension obviously becomes compromised if not disappear

- So it is an imperious necessity to put more ethics in finance . But how ?
- The behavioral assumption of the modern financial-economic theory is based on the rational-maximiser paradigm : Individuals are egoistic and tend to maximize their own interests.

- Since agents may act, if necessary, “with guile and deceit” to maximize their wealth, no agent can trust any other in the market.

As Norman Bowie the business ethicist said :  
“the conscious pursuit of self-interest by all members of society has the collective result of undermining the interests of all.

- Also at the heart of the modern economic and financial system is the principal-agent model of relationships which refers to an arrangement whereby one party, acting as an agent for another carries out certain functions on behalf of that other

- Contract also is an essential element of the financial system.
- Transactions are based on trust
- Building trust is a central ethical requirement, closely related with reputation

- For trust to work, agents must be intrinsically trustworthy.

In the finance paradigm the act of honoring trust in and for itself has absolutely no value.

- Personal ethics is based on :
- trustworthiness,
- loyalty,
- fidelity,
- stewardship,
- concern for others (underlie the traditional principal-agent relationship).

- Challenging the current financial paradigm :
- Dobson and the virtue approach
  - Challenge the behavioral assumption
- Walter and the questioning of the Brownian motion
  - Challenge the current mathematical measure of risks.

- As Dobson said, a proper theoretical understanding of finance requires a necessary foundation in some set of ethical assumptions.
- He then argues that the best way to conceive this ethical basis and the most useful basis from a practical point of view is that of “virtue ethics”.

- Dobson want to enlarge the financial paradigm to encompass a moral dimension supplied by the virtues ethics theory.
- This theory exhibit 4 basic attributes
  - Importance of virtues of character, such as honesty, perseverance, consistency and fairness,
  - role of the community
  - the central role of sound judgment
  - the importance of moral exemplars

- Virtues in the context of business (Goodpaster)
  - Prudence : neither too short-term not too long-term in time horizon
  - Temperance : neither too narrowly materialistic(want-driven) nor too broadly dispassionate (idea-driven)
  - Courage : neither reckless nor too risk-averse
  - Justice : neither too anarchic regarding law nor too compliant
  - Loyalty : neither too shareholder-driven (private sector) nor too driven by others stakeholders(public sector)

- Walter approach is totally different :
- For him it is necessary to analyze the mathematical evaluation of risk. The Brownian motion, the virus, is an intellectual ill that attacks our concepts of uncertainty and leads us to believe that it is possible to control and calculate risks that can then be factored out.
- Walter is today director of the chair of Ethics and Finance in the Catholic Institute of Paris

- But now what can we do ?
- Implement real ethical codes of conduct in the financial firms for good corporate practices
- Organize the financial profession in order to insure an ethical behavior of its members.

- Corporate practices : 5 recommendations by Prof Domenec Mele Carné (IESE Navarra)
- Have the selection criteria include moral honesty and ethical values
- Properly consider the risks of growth and debt and avoid situations that force deceitful or fraudulent maneuvers to be made
- Promote fairness in decision making, along with effectiveness and efficiency

- Establish the appropriate rules and control processes that provide transparency and relevant information, while impeding excessive or unfair actions
- Develop a culture of accountability and honesty, through several means, especially through prudent, exemplary leadership

- Organization of the financial profession (Pellerin & Casimiro)
- Integrate all professionals of finance (including the Chief Executives) into a unique professional body consisting of various chambers that will represent the different professions of the sector.

- To be sure that candidates have a sufficient basic grounding in the ethics in finance, to be admitted to the profession one would be obliged to pass a non-financial examination on ethics in finance which will have as much as importance than the professional exams.

- Professional exams would address technical and deontological issues; preparation would be through universities that would develop modules and suitable training, in partnership with the Order. With the creation of a professional order, financiers would no longer be considered by their clients a mere individuals, but also as members of a professional chamber, whose reputation would affect all its members.

- Principles to incorporate in the ethics code
  - Integrity
  - Objectivity
  - Competence
  - Fairness
  - Confidentiality
  - Professionalism
  - Diligence
  - Transparency
  - Accountability

- To conclude on a more positive mood :there is an encouraging trend :
  - Ethical finance : some initiatives in finance, show that we are on the way to re-discover the instrumental function of finance in support of the economy with an increasing consideration of environmental, social and governance issues in investment decisions and services being offered.
  - NGOs/ Foundations, Finance Watch initiative
  - Increasing number of chairs in ethics and finance

## Short bibliography

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