Ethics in Finance as the Result of a Strong Systemic Commitment

Auribus Teneo Lupum

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Abstract

The financial world is pragmatic, eager to gain profits, and has a core purpose: increasing wealth, not for everyone but for specific groups of people. Equally, finance relies on other people’s money to obtain positive economic outcomes. The financial business has also become more transactional than relational and has always been prone to market failures. On top of that, the natural risks that are proper in financial activities are transferred in the markets by moving liability from hand to hand until it turns out to be too late. Bearing in mind these unique features, is there such a thing as ethics in finance? Can we talk about ethical financial institutions? If there is and we can, is this a subject matter that can be dealt with by establishing general standards of behavior aimed at being applied to all people and institutions involved? Establishing rules of conduct has been the role of regulators. Moreover, subjecting public and private institutions to monitoring and sanctioning noncompliance with such rules has been the role of states. Then, what is the purpose of financial ethics? The complex decisions people and institutions must make every day while managing other people’s money and financial assets need an approach compatible with the purpose of such businesses. Thus, it appears that relying on traditional ethics in the financial markets to correct improper behavior seems to be a dreamer’s desire rather than a real
solution. Therefore, this chapter proposes some ideas that could contribute to the construction of an adequate ethical approach to the provision of financial services in a globalized financial world.

**Keywords**

Ethics in finance · Responsibility of financiers · Financial services ethical practices · Ethical standards in the financial world · Governance of financial institutions · Ethics of risk management · Financial scandals · Capital requirements to gain ethical behavior · Ethics in finance and regulation · Prudential regulation and ethics

**Introduction**

The financial world has unique features, some of which are pointed out in the first section of this document. Taking into consideration these characteristics, is there such a thing as ethics in finance? Can we talk about ethical financial institutions? Can we get access to ethic financial services? What do these questions mean for a financial institution aimed at maximizing profits? What do they imply for the board of directors of such companies? For their employees that are hired to generate outstanding economic outcomes? All in all, what is the purpose of financial ethics? This chapter will not provide the answers to these fundamental questions. It contains reflections from a lawyer that has witnessed and studied financial crises and financial scandals for more than 25 years. The complex decisions people and institutions must make every day while managing other people’s money and financial assets needs an ethical approach compatible with the purpose of such businesses. That is why this chapter does not rely on ethics experts, but by reflecting on the words of the main executives at central banks, financial regulators, and supervisors, when speaking about financial ethics. After decades of establishing a comprehensive set of standards aimed at avoiding financial crises, massive financial turmoil occurred in 2008. At the time of this paper, more than 10 years have passed, and the world still resents the economic consequences of these grim events. On top of that, the SARS-CoV-2 pandemic has hit the world, and with it, has shown the true colors of financial entities with relation to troubled debtors. Certainly, regulation has been an important instrument for impeding reckless and improper behavior in the financial markets. However, it has not clearly been enough to stop greediness and selfishness. If gaining profits is the incentive that guides everyday behavior for people and institutions involved in the financial markets, losing all of them should be the consequence of profiting through improper conducts. Requiring more capital from shareholders and provisioning losses related to bad behavior should be the subsequent step. If the financial industry starts adopting these criteria when there is a breach of ethical behavior, this strong systemic commitment will lead to *auribus teneo lupum*. 
Some Features of the Financial Markets That Make Them Unique

There are different financial services provided in the financial system. In general, adopting a broad definition of financial services, the financial services industry is composed of commercial banking, investment banking, insurance, and in some cases, asset management (Group of Ten 2001). There are specific institutions that provide these services such as depositary institutions (banks), securities firms, and insurance companies. Along with these activities and institutions, there is financial market infrastructure that facilitates the provision of financial services within the financial markets, whether local or international. Payment systems, central securities depositories, securities settlement systems, central counterparties, and trade repositories are examples (CPSS 2012). At the same time, during the past decades, the provision of financial services is conducted through multinational or domestic financial conglomerates (JF 2012).

A key issue to consider is that financial services are produced by and offered to people. At the same time, in the real world, financial institutions are created, run, and developed by people. From the legal perspective, this subject could be argued. A corporation is usually considered a legal person. Some legislation even suppose that, in some cases, corporations even have, will, or could be criminally prosecuted as legal persons. However, this representation of a corporation as a legal person at the end will need a human or a group of human beings able to make decisions within the company, to represent it to third parties, and more importantly, a person or group of people that are registered as its owners. Equally, financial institutions cannot think by themselves. Financial institutions as corporations depend on their charters and on the regulation applicable. They do not have a free will. They cannot make decisions. The conduct of a financial institution depends on the people that own, manage, or represent it.

This human element is at the core of our reflections on ethics in the financial world, and it supposes a paradox. It is so, since financial institutions depend on human beings. But, at the same time, human beings related to those institutions, whether owning them, managing, or working for them, must follow the corporation’s charter and comply with decisions made by its owners and the applicable regulations.

Thus, this document argues that when considering ethics within financial institutions, one has to bear in mind that such entities do not have the capacity to think, to make decisions, or to carry out actions on their own. There must always be a group of human beings agreeing upon, instructing, and implementing such conduct. Similarly, such groups of human beings have different duties that will depend on the role they play within the institution. But nevertheless, all interested groups involved must comply with private (charter) and public regulations (i.e., corporate law, banking, and financial and insurance regulation, as appropriate). Furthermore, the owners could provide an outline of distinct behavior within the institution by providing in its charter, specific ethic commitments for the board of directors and all people involved in the company. Quite often, they do not do it.
As a consequence, an ethical financial institution per se does not exist. The ethics of the institution will depend on the people involved within. Simultaneously, the conduct of people that, for instance, manage the financial institution will be shaped by the type of business the company must run according to its charter and by the interests that every person and group working in the financial institution has (Stingler 1980; for a different approach, Thaler and Sunstein (2009)).

In this sense, the ethics of a financial institution is a complex issue. First, it is the result of the relationship between people’s duties and their own interests within the company. Second, it is the consequence of the purpose and activities determined by its shareholders in the company’s charter. Third, it is the result of compliance with the state’s regulations. It is a worldwide lament that financial systems are over-regulated or are the subject of an inadequate regulation (Stiglitz 2001). Therefore, conduct of business shaped by regulations may be susceptible to loopholes and gaps that may allow room for misconduct that, in some cases, could be considered lawful but not ethical. Fourth, people do not behave in a vacuum. There is a culture that shapes the conduct of every human being in his country, city, neighborhood, and profession, as well as his home (Awrey et al. 2013).

The financial world is pragmatic, is eager to gain profits, and has a core purpose: increasing wealth, not for everyone but for specific groups of people. Shareholders are usually the focus of this analysis. Shareholders, as the main providers of capital for the company, are entitled to make decisions regarding the financial institution according to its charter and the corporative law applicable. From its creation, it is expected that a financial institution, as a corporation, must produce profit. And, this output belongs to the shareholders not the financial institution. That is the purpose of its creation since they provide capital as well as all different means that enables it to undertake business and be profitable. Furthermore, governments do not allow the establishment or the existence of a financial institution if it does not succeed in the industry by creating revenue.

However, financial institutions are not lucrative only due to having adequate capital. Such legal entities are composed by groups of diverse people that perform various activities that, in the end, make it gainful. And they do so in a highly competitive industry. The use of incentives such as employee compensation is a strategy that could yield economic benefits for the financial institution as well as for the directors and employees involved. Nevertheless, it may create negative effects for the company’s reputation and its financial health as it may end up rewarding sales volume and short-term profits (Mminele 2014). Sales managers, marketing executives, and more importantly, the members of the board of directors could be negatively influenced in their conduct of business due to such incentives. Therefore, along with the establishment of said incentives, there must be a culture of malpractices control.

Another important feature of financial institutions is that they depend on other people’s money to obtain positive economic outcomes. This is the main component of commercial banking. The origin of banking businesses is based on the transformation of deposits into credits. Banks do not perform loans only with their own
capital, but mainly with their client’s money. Equally, in the stock markets, companies issue securities with the aim of getting access to third parties’ capital. At the same time, asset management relies on money of third parties as well. All financial companies need to perform their business on economies of scale (Stigler 1958). Thus, people managing and working for such institutions are in contact, on a daily basis, with enormous amounts of money and assets that belong to third parties. In addition, the changing nature of financial business has transformed them into much more transactional rather than relational operators (Carney 2014). As there are more intermediaries, the link between the original service provider and the end-consumer starts to erode (Mminele 2014). As a consequence, confidence between parties, which is at the origin of every financial transaction, starts to fade.

At the same time, there are important market failures in financial business (Stiglitz 1989): Asymmetries of information are present in almost all financial transactions. This might mean reaching unfair agreements for parties involved in a financial transaction. However, it could hopefully be resolved by trust, transparency, and professionalism. But, sometimes, it is not. Financial markets are also prone to monopolistic and oligopolistic structures. These features may create competition problems as well as abuse of the financial consumer. More importantly, financial markets could give rise to negative externalities able to crush the overall economy. Financial crises are the more radical example of them. And such crises expose the moral hazard issue in the commercial banking sector: Banks enjoy an implicit guarantee of government bailout. In other words, banking business might mean, for shareholders and the institution management, the privatization of profit and socialization of losses (Subbarao 2009).

Another central aspect of financial institutions is that the natural risks that are proper of their activities are transferred in the markets moving liability from hand to hand until it is too late for the final bearer (JF 2013). All financial assets and financial operations carry financial risks that should be recognized by all parties involved. When those risks are not clearly identified and disclosed, by mistake or on purpose, legal and ethical issues start to arise.

These special characteristics of the financial institutions – using customer’s money to gain profits, being built on economies of scale, becoming more transactional rather than relational, being prone to market failures and moving risk exposure – are the basis for a crucial type of regulation called prudential regulation. It is aimed at creating behavioral incentives for managers, employees, and shareholders by imposing capital requirements when risks associated with the financial institutions’ activities are not properly controlled. If the company is undertaking important risks, it will require more capital from its shareholders (Walter 2010; see also Basel Committee 2020; IOSCO 2017; IAIS 2003). Therefore, people within the organizations must behave with prudence, otherwise their conduct will increase the cost of doing business for the financial institutions and their owners. This strategy has been at the center of the work of regulators and supervisors all over the world over the past few decades (Baquero Herrera 2007). And it seems to work, as will be discussed in the following section.
How to Control Conduct in the Financial World?

Past and recent financial crises always emphasized that the financial world continuously needs special legal and supervisory rules (Kindleberger 2012). State intervention through the introduction of different types of regulation, establishes minimum standards of behavior for people and institutions involved in the provision of financial services (Bailey 2013). Therefore, instituting rules of conduct has been the role of regulators. Moreover, setting up institutions public and private for monitoring and sanctioning not compliant with such rules has been the role of states (Crockett 2003). Certainly, the protection of financial stability has become a global public good.

The strategy for guarding global financial stability was set up at international level in the second half of the twentieth century. Due to several financial crises that had occurred in emerging economies with the capacity to affect financial markets all over the world, the G-10 group at the 1996 Lyon summit discussed the issue. As a result, global leaders imposed different international institutions the duty of issuing global standards of regulation and supervision of financial institutions (BIS/IMF 1997).

During the last few decades, such work has been performed by standard setters specialized in the regulation and supervision of specific financial markets. For commercial banks, the Basel Committee on Banking Supervision focused on issuing a comprehensive set of regulatory and supervisory standards related to that market (BCBS 2006a, b, 2020). For securities, the International Organization of Securities Commissions addressed financial activities (IOSCO 2003), whereas the International Association of Insurance Supervisors did the same for the insurance industry (IAIS 2003). At the same time, the committee on payments and market infrastructures started to make recommendations about the safety and efficiency of payment, clearing, settlement, and related arrangements (CPSS 2012). While all these standard setters regulated financial institutions and set up the minimum requirements for their adequate regulation and supervision, other international institutions focused on the core aspects of financial activities. Among them, financial consumer protection (OECD 2011); pension funds (IOPS 2006); corporate governance (OECD 2015); effective deposit insurance systems (FSF 2011); effective resolution regimes for financial institutions (FSB 2014); insolvency and creditor rights (WB 2015); and measures to combat money laundering and terrorist financing, as well as the financing of proliferation of weapons of mass destruction (FATF Recommendations 2019).

Notwithstanding such efforts, the global subprime crisis occurred (Dudley 2009). It spelled out again that the complexity of financial markets makes them exposed not only to their inherent risks, but to human behavior, exacerbated by greediness and selfishness (Mahapatra 2012). However, the reaction to the financial crisis did not change the strategy already in place. It focused on making it stronger (Restoy 2017). A new powerful standard setter was established by the G-20: The Financial Stability Board (FSB) was entrusted with the task of promoting global financial stability. The regulation of financial conglomerates was also strengthened (JF 2012), and the Basel Committee on Banking Supervision clung on to capital adequacy regulation (BCBS
At the same time, governments made sure that moral hazard was tamed by limiting bailouts of troubled financial institutions (Carstens 2019).

Why, after the recent financial crises, the focus of the main regulation in place, aimed at avoiding systemic risk, is still the same? Because it seems that the approach is going in the right direction. Regulation usually promotes certain behavior on people. It can be done by prohibiting and sanctioning bad conduct and malpractice. This has been the traditional practice. But also, it can be achieved by creating incentives that entice people to perform in the way regulators want. This is the case of prudential regulation. During the past decades, it has been issued with a strong emphasis on creating the right incentives (Bailey 2016).

If financial institutions are eager to gain profits, introducing regulation able to reduce them when senior managers do not perform in the way prudential regulation requires has proved to be an efficient incentive to get administrators to behave. At the same time, requesting more capital from shareholders when financial activities grow riskier has become the core prudential rule in the financial world. In both cases, senior managers that are accountable to the shareholders must explain to them why profits are lower, and they must provide more capital due to poor management decisions.

Then, the prudent conduction of business is not the consequence of introducing prohibitions or criminal prosecution. It is not due to a strong ethical commitment of senior managers. Regulators have understood the importance of aligning the purpose of regulation with the nature of the financial industry. This document proposes that ethics in finance should follow suit.

**Is There Such a Thing as Ethics in Finance? The View of Financial Regulators, Supervisors, and Central Bankers**

Everyone seems to accept that, apart from an enabling environment, proper infrastructure, skills, and knowledge, a responsible and ethical behavior of the participants is a prerequisite for efficient and well-functioning markets (Anwar 2012). Therefore, it is important for the financial system “(...) to cultivate a situational environment and broader system that encourage genuine professionalism and integrity of the people in the system” (Ghaffour 2017).

Rule books are often imposed by regulators to introduce ethics on financial activities (Joshi 2013). Adopting a code of conduct, a code of ethics, or the like within the financial institutions is a usual step that reflects a corporate effort on ethics that might only exist on paper (Dombret 2015). There is sometimes a gap between what banks claim and what they do (Carse 1999). Creating a corporate culture able to influence the behavior of each individual employee is desirable (Baxter 2019). But, as Menon states, culture and conduct practices are uneven in the industry as some financial institutions “(...) are only starting to develop tools and indicators to obtain a holistic, cross-functional view of the culture within their organization” (Menon 2019). It might take years with few results if such culture is not aligned with the nature and main purposes of the financial institutions.
Such organizations are created to gain profits by selling financial products. More profits usually mean higher bonuses for employees. As Khan describes it, “(...) individuals in the financial markets are usually specialized in science and technology who might tend to self-interest and greed,” which might lead them to mis-sell products to unsophisticated investors/borrowers. Thus, he proposes that all those who join finance professions “(...) must be required to have gone through value-based education and socially relevant experiences during their college days” (Khan 2012). In a word, educational institutions must provide to the financial markets a work force with individual morality and social ethics aimed at responsible financial behavior (Ferguson 2004). Will this dream come true some day? What do we do meanwhile?

Others in the same direction propose that the foundations of ethical behavior in financial institutions “(...) go well beyond corporate culture and policies. These are rooted in one’s moral training, lessons parents and school teachers have taught from early childhood on which affect not just individual behaviour the competitive business environment and indeed society as a whole” (Joshi 2013). In this sense, educators must have helped them to develop “(...) the ethical compass and the moral fortitude to adhere to doing things the right way” (Tetangco 2009). What happens if such requirements have not been fulfilled by parents and school teachers?

Some regulators’ approaches understand ethical behavior as to “(...) set a good example and be a role model” Narube (2009). In this sense, it is expected that when people see something wrong they say something. As Dudley proposes, “cultures do not change simply by exhortation.” Therefore, financial institutions must “(...) encourage a culture that spots issues and raises concerns early.” To do so, “managers have to lead by example” and employees “(...) who speak up should be recognized” (Dudley 2017; See also Desario 1997).

Stiroh, in an interesting speech, relates ethical behavior with corporate governance. He claims that misconduct in the financial sector is not just the product of a few individuals or bad processes, “(...) but rather the result of wider organizational breakdowns, enabled by a firm’s culture.” To tackle this problem, he focuses on cultural capital. In his own words, it is “(...) a type of asset that impacts what a firm produces and how it operates.” So, “(...) in an organization with a high level of cultural capital, misconduct risk is low and observed structures, processes, formal incentives, and desired business outcomes are consistent with the firm’s stated values.” Therefore, supervisors must increase their focus “(...) on firms’ decision-making practices and behaviors as a core aspect of good governance” in order to “(...) understand how a firm manages misconduct risk and to improve resiliency and reduce the potential for unwanted disruptions to financial intermediation” (Stiroh 2017).

On the other hand, when analyzing the subprime crisis, Bini considers that the appeal to ethics and individual morality is an important starting point to correct the distortions that he found in his studies of such financial crisis. But to him, it is not enough. It is so, because “(...) unethical practices make it possible to obtain higher returns, those who do not follow them are likely to be penalised. In other words, those who comply with the dictates of ethics may not perform economically so well
as those who do not, and so may find themselves out of the market” (Bini Smaghi 2010).

Another important factor that contributes to making it difficult to attain ethical behavior within financial institutions has been pointed out by Chan: the short termism of shareholders that laid pressure on bank management: “(…) board directors and senior management were, and still are, under constant pressure to pursue higher RoEs. It is not difficult to see why capital raising, which improves the resilience of banks, is often rejected or delayed as it is negative for share prices in the short term. The result? Banks have no choice but to leverage up and take bigger risk in order to meet the targets that the shareholders demand” (Chan 2015). So, as Gjedrem Sijbrand states, focusing on “managing for value” only, banks lost track by preferring both short-term and instrumental thinking. “Clients became instruments to extract money from in order to maximize profits and thus increase shareholder value. Employees were hired on the basis of their capacity to make as much money as possible and as fast as possible, rather than for their capacity to make a sustainable contribution to the bank” (Sijbrand 2013).

At the end, as Mahapatra recognizes, “(…) the malaise that we have seen in the financial sector might in fact be a result of degradation of value systems in the society as a whole” (Mahapatra 2012). Is there then, a solution? Would it be possible to move forward from “ethical drift” to “ethical lift” in the financial markets? (Shafik 2016; Carney 2017).

Perhaps, as certain supervisors understand it, behaving ethically “(…) is not only the right thing for banks to do, it also makes sound business sense” (Carse 1999). Thus, not only ethics should be integrated into business strategy, but it also must be considered within the nature of financial institutions and their businesses (Dudley 2014). Following Villeroy de Galhau, “Good performances can neither excuse nor compensate for questionable ethical behaviour. Results obtained at the expense of ethical standards should not be rewarded. On the contrary, they should be penalised in order to send the right message with regards to expected behaviour, including from the managers of the employees concerned” (Villeroy de Galhau 2018). How to achieve this? The following section proposes some ideas that could contribute to the construction of an adequate ethical approach to the provision of financial services in a globalized financial world.

### Summary and Final Remarks

The last section “Is There Such a Thing as Ethics in Finance? The View of Financial Regulators, Supervisors, and Central Bankers” summarized the views of supervisors, regulators, and central bankers from different parts of the world. They were from speeches delivered in core events related to the financial industry. However, the approach to ethics from those authorities seems to be traditional, insufficient, and in some cases, naïve; as ethics is concerned with the norms of human social behavior, regulation, and supervision too. Although ethics and laws are different, in the end, both are aimed at creating certain human behavior.
Financial activities are considered a public interest. That is why the provision of financial services, being a private and legal activity, is always authorized by states all over the world. It is strongly regulated and duly intervened by supervisory authorities, which have the power to require compliance. In these markets, regulation and ethics are very close in the aim of requiring the performance of a certain desired conduct, from the ethical point of view because they are socially important, from the state because they are related to the public good.

As stated in section “How to Control Conduct in the Financial World?” Supra, financial markets are severely regulated by states. Even though the provision of financial services is a private activity, governments soon realized that such business involves negative externalities that affect the whole economic system. Avoiding financial crises has become a priority for regulators, supervisors, and central banks, all over the world. Different strategies were adopted. None of them have been successful. Financial crises will inevitably arise. However, the approach, of establishing regulatory incentives that induce shareholders, senior officials, and employees to use prudential conduct when providing financial services, has proved to yield significant outcomes. In this sense, this type of regulation has made an important finding: In order to be successful at achieving certain expected behavior from people involved in the financial world, incentives must be related to profits and capital.

By taking into consideration the purpose and structure of financial institutions as corporations, as well as the nature of their operations, slowly but surely, prudential regulation has been able to create a culture of adequate management of financial risks. And it has been done not by establishing codes of conduct, urging to require good values, safe backgrounds, and meaningful education to their employees, or via self-regulation or criminal law, but with a regulatory tool that is strong enough to make sure that everyone within the financial institution will try not to affect shareholders’ revenue or capital.

The complex decisions people and institutions must make every day while managing money and financial assets need an approach compatible with the purpose of such business. It seems that relying on traditional ethics in financial markets to correct improper behavior is a dreamer’s desire rather than a real solution. It is so because financial institutions as profit maximizers do have a clear purpose that will not change. Gaining profits is the incentive that guides everyday behavior for people and institutions involved in financial markets. It is the real ethos of these private activities. There is nothing wrong with it, if we all understand it and therefore start controlling such purposes from a practical perspective.

Governments have placed their focus on financial stability issues. It is acceptable as financial crises create poverty and greatly affect people’s lives and assets. However, they are important issues that must be properly dealt with. For instance, abuses of consumers in financial services, improper handling of customers’ assets, mis-selling of financial products, and lack of transparency in the establishment of interest rates related to the provision of credit. If financial institutions have gained revenue from such conduct and their employees have also pocketed bonus from it, losing all of this should be the consequence of profiting through improper conduct. Requiring
more capital from shareholders and provisioning losses related to bad behavior should be the subsequent step.

In a word, it is time that regulators and financial institutions via self-regulation consider introducing reputational risk within the framework of capital adequacy requirements as well as within the accounting rules that require more provisions, when management makes risky decisions or when reputational events occur. Reputational risk is not a financial risk. However, operational risk, being a nonfinancial risk, has already been introduced into the capital adequacy framework. If the financial industry and governments start adopting these criteria when there is a breach of ethical behavior, this strong systemic commitment will lead us to *auribus teneo lupum.*

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