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Ethics in Finance: Why is it such a problem?

BY JOHN HENDRY

Despite the best efforts of all concerned, the financial sector continues to have a bad reputation for illegal and unethical behaviour and to be more prone to ethical lapses than other business sectors. John Hendry explores why this should be, and what might be done about it in practice.

Why has the financial sector such a bad reputation for illegal and unethical behaviour? Partly perhaps, because of ignorance and prejudice. Most people have very little understanding of finance, and throughout history its practitioners and their core activities – lending, borrowing and speculative trading – have been seen as morally distasteful. Nowadays everybody who has a bank account is a lender, everybody with a pension or life policy is a speculator, and most of us are also borrowers, but the moral stigma somehow remains. There is more behind the bad reputation of finance than that, however. While it's difficult to get a meaningful measure of such things, the financial sector almost certainly *is* much more prone to ethical lapses than other business sectors. There may be a problem of perception but there is a real problem as well, and it is a problem that refuses to go away, despite the best efforts of firms and regulators to address it.

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This situation prompts a number of questions. The first and most important is: what can be done? Good intentions are clearly not enough and while there have been all sorts of suggestions, from enforced restructuring of the banking sector to capping bankers' bonuses and from enhanced compliance

regimes to the requirement that bankers swear some kind of hippocratic oath, none of these seem particularly promising. We need to come up with something better, and to do this we need to ask two further questions. What kinds of ethical problem are we up against here? And what is it about the financial sector that gives rise to these particular kinds of problem?

The Problems

Like any other business, or any other competitive activity, finance has its share of fraudsters and cheats, its Madoffs and Levines, but this is not the heart of the problem. What is characteristic of ethical lapses in finance is not intentional, but unintentional wrongdoing – not immorality so much as moral oversight or neglect. Three kinds of problem in particular stand out.

Both the financial labour market and the market for financial services are demonstrably inefficient and competitively highly imperfect.

The first, and the most characteristic of the sector, is exemplified by the mis-selling of complex derivatives (Goldman Sachs's Abacus products or the customised swaps sold by Bankers Trust in the 1990s), the manipulation of sell-side research and IPOs, the misrepresentation of financial assets and liabilities (off balance sheet SIVs, inappropriate mark-to-model valuations or Lehman's Repo 105s), LIBOR rate-fixing, etc. In all these cases and many others it is clear from the outside – and clear in retrospect even from the inside – that the actions taken were wrong. But they didn't seem wrong to those engaged in them at the time. They were perceived, perhaps, as stretching the rules, but not as breaking them, and it was the rules of the game, the technical norms, that were perceived as relevant, not the social and moral norms that underpinned them. Ethics just didn't enter into the matter – and that was precisely the problem.

The second kind of problem, and the kind that impacts most immediately on the public, is exemplified by the mis-selling of personal or small business financial products: split caps, endowment mortgages, personal pension plans, payment protection insurance, etc. No-one here set out to deceive. By and large all those involved set out to provide a genuine service to the customer. But the people who designed the products failed to think through the possible consequences, and the people who sold them on the ground simply didn't know enough about them to know whether they were or weren't appropriate.

The third kind of problem is not generally recognised as a problem within the sector, but needs to be recognised if progress is to be made. Its main public manifestation is in the debate over bankers' bonuses, but the underlying issue is much broader. It can be summed up in two contradictions. First, the core function of the financial sector is to secure the most efficient *allocation* of financial capital *across* the productive economy, but its most significant achievement over the past 30 years has been the large scale *extraction* of financial resources *from* that economy. Even in the wake of the financial crisis, financial practitioners have not only been getting richer than anyone else but also getting richer at the expense of everyone else. Second, the core value of the sector is the maintenance of free, efficient and perfectly competitive markets, but both the financial labour market and the market for financial services are demonstrably inefficient and competitively highly imperfect. Again, no-one has sought intentionally to bring this about, but that doesn't mean it's not a problem.

The Causes

These kinds of problem don't arise because the people going into the sector are any less ethical, or any less ethically attentive, in themselves, than those going into other sectors. They may be motivated to make money rather than to save lives but that's not exactly unusual in business, and most are attracted to finance simply because they're good at it. Like anybody else they want to advance their careers and make money, but like anybody else they also start out with a predisposition in favour of a principled, moral approach. They believe that people should in general behave ethically, and they include themselves in that. Moreover, although there may be some fuzziness around the edges, they have a pretty good idea of what is right and what is wrong and when it comes to a conscious choice they would prefer to do what is right.

The problem is that it doesn't generally come to a conscious choice, and the root of that problem is in finance itself, in the norms and values inherent in financial practice and the way these affect people's behaviour. Two sets of factors stand out, one relating to the nature of money and the financial system, and the other to the norms and techniques of financial practice.

All businesses deal with money, but finance is concerned exclusively with money and monetary products, and money and morality always have been, and always will be, uneasy bedfellows. Unlike the goods and services produced or traded in other sectors, money has no physical impact on society, no immediate psychological impact, and no obvious moral effects. It also has no intrinsic value and in this context little symbolic value. Its value is an exchange value, and of a particularly pure form. Most things with exchange value – reputation and social standing, for example – are culturally specific and tied to particular communities. Money is culturally neutral and has a global reach. It is not tied, as goods and services are, to the context of a community, and since moral values are essentially community values – indeed, they are what hold communities together – money eludes them. The result is that the activities of the financial sector are effectively dissociated from the physical and moral communities that shape all other business sectors.

On top of this, money is itself inherently de-moralising. As the ancient Greeks already recognised, it is the unique object of unlimited desire. The greed of the glutton or libertine is inherently self-limiting and its immorality painfully visible, but the greed for money knows no limits. As behavioural economists like Bruno Frey have shown, money also displaces or crowds out emotions and moral values.[1] And as the anthropologist David Graeber has recently argued, it de-moralises personal debts and obligations.[2] Our moral obligations are, in a very important sense, non-measurable. Whatever may be paid or repaid, they can never be squared off and closed. As soon as debts become monetarised, however, the values and obligations associated with human exchanges are lost, and because morals are always associated with values and with personal obligations or commitments, they are lost too.

These effects are accentuated by the norms and techniques of financial practice. The highly technical nature of financial products and practices closes people off from wider considerations. As in other technical fields, the technology absorbs people's attention and presents itself as morally neutral. The game-playing nature of financial trading also blinds people to its real consequences: no matter what controls are in place, there is always a temptation to act as if their were no repercussions, as if the game could just be re-set if things go wrong.

Finally, both the practices of the financial sector and the education of its practitioners are inevitably framed by the theory and assumptions of financial economics. All people are assumed to be financially self-seeking, opportunistic, rational and competent monetary wealth-maximisers. They are out to make as much money as they can, with no moral scruples.

Formally speaking, this last assumption carries no moral implications. It's an assumption as to how people are, and neither the assumption nor the theory say anything about how people should be. It acquires moral force, however, from the proposition – shared across the sector – that unrestrained financial self-seeking is ultimately to the benefit of society as a whole. The argument underlying this, which in ethical terms is an argument from rule utilitarianism, is seriously flawed. (Very briefly, whether or not financial self-interest maximises total wealth is unclear, but distribution effects mean that it almost certainly doesn't maximise total utility, on any plausible definition of that.[3]) But the proposition is deeply embedded in the culture of finance and it provides a curious cap to the de-moralising effects of money and the financial system. For all the reasons noted, finance is deeply amoral, but that amorality is also perceived, within the sector, as a (morally) good thing.

The Remedies

What, in the face of all this, can be done? Some critics of finance have argued the need for wholesale value change. The suggestion mentioned earlier, for example, that bankers should take an oath dedicating themselves to the interests of their customers was part of a report on "Virtuous banking" by the think tank *ResPublica*, which took very much this line.[4] While the report was full of good intentions, however, it served mainly to show just how out of touch policy wonks are with the real world. While norms and values can evolve over time they cannot simply be re-written or re-engineered, and there is no way in which we can plausibly separate the culture of finance from the cultural effects of money, globalisation, or economic theory. Somehow, the solution has to come from within that context.

How this might happen remains unclear, but legal and regulatory impositions have a very poor record of success. Market forces operating through the medium of internet-based self-correcting systems may be a more promising possibility, but that would pose ethical challenges of its own and in the short term the inefficiencies of financial services markets pose a barrier

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to change. The best hope probably lies with a process of professionalisation. There is already in the sector a commitment to training and education, and there is an interest in reputation. When people get rich they may still seek to get richer but they also begin to seek respectability, and in a technical field with a monopoly of expertise professionalisation is a natural route towards this. Professionalisation typically brings with it minimum levels of knowledge and on-the-job training, and if applied across the sector this would itself address some of the issues to do with the mis-selling of personal financial products. Proper professionalisation, which is more than just some courses and letters after your name, also brings with it enforceable ethical standards, including a clear commitment to both the public interest and the welfare of the client. Critically, in a professionalised practice, all professionals are personally responsible for the actions of their teams. However thoughtless or incompetent the person with whom you are dealing as a client, there is a fully qualified named individual taking full responsibility for everything they do, or don't do. And while that mechanism is far from foolproof (the accounting profession, for example, has hardly been free of ethical lapses) it provides a strong incentive for ethical attentiveness.

About the Author

Dr. John Hendry is a Life Fellow of Girton College, University of Cambridge, and Emeritus Professor at Henley Business School. He has written extensively on business strategy, management and ethics and his most recent book is *Ethics and Finance: An Introduction* (Cambridge University Press). For this and other work see johnhendry.co.uk.

References

1. See for example Bruno Frey, *Not Just for the Money: An Economic Theory of Personal Motivation* (Edward Elgar, 1997).
2. David Graeber, *Debt, The First 5000 Years* (Melville House, 2013).
3. I discuss this argument at length in John Hendry, *Ethics and Finance: An Introduction* (Cambridge University Press, 2013), chapter 4
4. http://www.respublica.org.uk/our-work/publications/virtuous-banking-placing-ethos-purpose-heart-finance/