

Ethics: the Key to Credibility

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Alors que le monde s'enfonce dans une crise économique d'une ampleur historique, les créanciers et débiteurs potentiels sont de surcroît pris au piège d'une profonde méfiance réciproque.

Pourquoi les acteurs financiers transgressent-ils si souvent les règles d'éthique ?

It is in the very midst of gloom and disappointment that genuine opportunities for success most often come to the fore. Players are forced to sharpen their focus, and chaos puts them more thoroughly to the test. The very feeling that they must re-design the stage rather than abandon it in mid-crisis allows efficient ideas that are capable of exploring hitherto ignored avenues to flourish.

As the world wallows in an economic crisis of historic proportions, the moment has come to take a new look at financial operators' motives and guiding principles. Faced with the evidence that the origins of the present slump lay in financial markets, the press and, to an alarming extent, governments have repeatedly denounced professional practices in the sector. Such a climate of tension merely underlines how important it is to identify the true causes of today's global collapse and take steps to deal with them.

Yet, regardless of its origins, the main factor that is now causing stagnation in the financial sector (and related areas of the economy) to per-

sist is the lack of credibility among its players. Potential creditors and debtors are trapped in a web of profound distrust that is preventing such essential mechanisms as the financing of exports and capital goods from operating as they should.

Although this distrust is largely due to the fact complex risk-assessment models have been found wanting, it can be allayed, or prevented from recurring, by more effective guarantees of ethical behaviour. The purpose of this paper, then, is to identify the main areas in which financial firms and operators could comply more fully with ethical standards, thereby restoring credibility within the sector and society's faith in financiers.

Ethics: the main problem

Every economy needs financial institutions. Through them, savings are transferred to players who require additional injections of funds in order to invest or to cope with a temporary fall in returns without having to cut spending. Nor should it be forgotten that financial insti-

La principale explication est liée à ce que l'on appelle le dilemme de l'agence : si une option donnée offre à l'agent une meilleure opportunité de gain par rapport à une autre solution, plus profitable pour le mandant, l'agent sera confronté à un dilemme éthique.

Les plus gros problèmes pour la société résident dans diverses formes de comportements non-éthiques permettant, à court terme, de générer d'extraordinaires gains financiers à la fois pour les agents et les mandants.

Même si ces opérations ne portent pas préjudice aux intérêts des personnes directement impliquées, elles réduisent, dans les faits, la confiance des individus envers le secteur financier.

tutions meet society's ever-present need for housing, insurance and shareholder capital.

So, if the financial sector plays a laudable - indeed essential - role, why should financial operators violate ethical standards so often? The most common explanation (Dobbs, 1997) concerns what is known as the agency dilemma. This arises because financial services involve 'principals' delegating the use of their capital to 'agents'. According to the theory of economic rationality, these agents are entirely bent on satisfying their own desire for higher returns, regardless of the consequences. If a particular option offers the agent more opportunity for gain than one that is more profitable for the principal, the agent will be faced with an ethical dilemma.

Pro-principal unethical behaviours

There is a crucial flaw in the agency dilemma, for it underestimates the role of agents' 'class interests' and the importance financial operators attach to long-term gains. If agents fear that unethical choices may have long-term repercussions on their profession's or firm's reputation, or indeed their own, they may rationally decide to defer them. To encourage such moral choices, members of the financial sector have created seals of approval for operators well versed in ethical practices, such as the Chartered Financial Analyst (CFA).

The most serious problems for society as a whole lie in kinds of unethical behaviour that do not normally prevent those directly involved from maximizing their gains. Indeed, in the short term, many of them generate extraordinary monetary gains for both agents and principals. I will therefore refer to this as 'pro-principal' unethical behaviour.

The use of offshore structures to camouflage deficits yielded outstanding short-term gains for Enron shareholders and executives (Enron shares rose 56% in 1999 and 87% in 2000; in the same two years the firm's Standard & Poor's 500 rating rose 20% and fell 10% respectively). Investors in Bernard Madoff's hedge fund Ascot Partners stated that, before the scam came to light, there were consistent double-digit returns and serious reports of wealth creation (Lenzner, 2008).

Even though such operations do not damage the interests of those directly involved – at least, not in the short term – they do reduce society's faith in the financial sector as well as trust among potential creditors and debtors, for the following reasons:

- (a) they implicitly undermine the authority of social conventions;
- (b) they divert resources from activities in the real economy towards financial transactions that are not profitable in their own right; and
- (c) they tend to even out the risks inherent in transactions involving different kinds of financial assets.

ETHICS: THE KEY TO CREDIBILITY

Nous pouvons identifier quatre grandes catégories de comportements non-éthiques favorables aux mandants.

Premièrement, le non-enregistrement des valeurs réelles d'une société dans ses bilans comptables constitue une pratique contraire à l'éthique, qui bénéficie à la fois aux agents et aux mandants.

Certaines valeurs négatives peuvent ainsi être omises afin d'augmenter le cours de l'action de la société ou de réduire les primes des titres qu'elle émet.

Unethical behaviour by financiers for their own benefit and that of their principals is nothing new, nor is it accidental. For centuries, financial advisors have exploited legal loopholes to obtain competitive advantages that enable them to make greater profits than their rivals. In 2003-2007, financial centres (especially those in North America) were swimming in liquidity, and high-yield projects were in great demand. All over the world, institutions involved in financial operations often felt tempted to propose uses of capital which, although unethical, would generate outstandingly high returns - and they often found the temptation too great to resist.

The financial sector's success in providing bonuses, commissions and salaries well above the average in other sectors drew the attention of some of the world's brightest individuals - doctors, mathematicians, economists, biologists and many others. Lured by the prospect of vast returns, experts from all kinds of fields migrated *en masse* into financial firms to become vice-presidents, partners and analysts of derivatives, stocks, securities, foreign exchange and so on - an army of often brilliant minds working out how to exploit opportunities which in common-or-garden ethics would be quite out of bounds.

We can categorize four main kinds of pro-principal unethical behaviour: 1) failure to record losses or profits (of whatever kind); 2) creation of subsidiaries to carry

out questionable activities; 3) unsupervised transaction clearances; and 4) appointment of project managers who cannot be held accountable for losses.

Failure to record losses or profits

Failure to record real values on company balance sheets is a common form of unethical behaviour designed to benefit both agents and principals. Negative values can be omitted in order to boost a company's share price or reduce premiums on the securities it issues. Positive values, on the other hand, can be concealed in order to evade tax or facilitate shareholder or credit control by the manipulating party.

In the 1990s, a number of US companies jointly lobbied Congress to be allowed to omit encumbrances on company capital resulting from employee stock options. The lobbyists argued that any reduction in a company's book value would adversely affect its market value and so harm its own shareholding employees - whose welfare was the whole purpose of the policy.

The companies were proposing that a real fall in the total value of their assets should be concealed for the benefit of their shareholding staff and executives.

Something similar is now happening with public-private partnerships set up to help certain companies divest themselves of non-liquid assets, regarding the way in which

Deuxièmement, lorsque des filiales extraterritoriales sont utilisées pour réaliser des opérations discutables, c'est généralement en vue d'aider la société mère à opérer une évasion fiscale.

La troisième catégorie de comportements contraires à l'éthique est rendue possible par le fait qu'un grand nombre d'opérateurs financiers majeurs sont autorisés à constituer les deux parties d'une transaction financière donnée ; une transaction qui n'est soumise à aucune obligation de supervision par un tiers.

Ces opérateurs, autorisés à constituer toutes les parties d'une même transaction, sont ainsi en mesure de fixer des coûts très inférieurs par rapport à n'importe qui d'autre, en minimisant les risques impliqués.

the assets are priced. The companies in question argue that, if the assets are priced by the market, their value will not be sufficient to cover the companies' urgent need for capital. If, on the other hand, the companies themselves were allowed to price their assets - already due to be purchased with public funds - they could set values high enough to meet their capital requirements.

Once again, noble ends are being used to justify unethical means. Yet ethics cannot prevail - and hence trust among financial operators cannot be restored - unless the 'rules of the game' (which regulate the means) take precedence over all else. It is an ethical principle that the ends do not necessarily justify the means - and, given that the ends are so often claimed to be laudable, ethical regulation of the means becomes all the more essential.

Creation of subsidiaries

When offshore subsidiaries are used to carry out questionable activities, the usual purpose is to help the parent company evade tax. A company sets up branches in other countries where the tax burden is either smaller or easier to avoid (legally or otherwise). The parent company then incurs various fictitious or quite simply unnecessary costs towards its subsidiaries, bringing part of the company's capital under their control, so that it is subject to less tax. In some cases the subsidiaries are set up for the very purpose of generating costs for the parent com-

pany, which can then deduct them from its taxable income in the country of origin. Perhaps the most notorious case of tax evasion via subsidiaries involved the Enron company, which for decades devised ways and means of diverting funds to branches abroad simply in order to avoid paying tax. As so often, this was made easier by the existence of tax havens. In some of these countries the level of bank secrecy is such that legal entities can receive sums of foreign currency anonymously - and so the authorities have no way of checking whether the recipient is in fact a branch of the institution that has paid the money.

Since cracking down on tax havens and bank secrecy is now high on the world political agenda, we can focus instead on what makes companies engage in such illicit activities. The level of taxation in the country where the parent company is based may be considered excessive, damaging to the company's progress, and hence an excuse for the illicit practice. However, ethical behaviour - as referred to above - has to apply not only to the ends, but also to the means used to attain them.

Unsupervised transaction clearances

The third kind of unethical behaviour can occur because a number of leading operators are authorized to represent both sides in a financial transaction without any need for third-party supervision. One case in which this played a key part was

Les agents pourraient répondre qu'en sous-évaluant les effets nocifs des risques impliqués, ils s'épargnent, à eux, mais aussi à leurs mandants, des coûts superflus. Néanmoins, si l'on peut tirer une leçon de la crise actuelle, c'est qu'il ne faut jamais négliger les risques.

Au début du vingt-et-unième siècle, le niveau de risque réel accepté par le secteur financier est devenu exorbitant.

Les résultats n'en sont aujourd'hui que trop évidents : de nombreux projets ont été financés avec un niveau de risque inacceptable et les risques n'ont que très rarement été contrôlés de façon appropriée.

the company set up by Bernard Madoff, an operator who was licensed to conclude transactions without supervision of any kind. This evident lack of transparency eventually gave Madoff the front he needed for a type of financial scam known as a Ponzi scheme.

Although such practices are not unethical in themselves, they do give rise to situations in which unethical choices are hard to resist. Having the power to determine the value of a financial transaction, even the most well-intentioned operator will tend to underestimate potential risks and the likelihood of their occurring. The final value of the transaction will then be such that the dividends accruing to the principal - and above all to the agent - will be exceptionally high. The discount on these profits that would normally be required to offset the likelihood of various setbacks occurring will be kept to a minimum, resulting in an artificial transaction and surreal values.

Agents may argue that, by underestimating the damaging effects of the risks involved, they are saving both themselves and their principals unnecessary costs and hence achieving an 'optimum' value for the transaction. However, if one lesson can be learned from the current crisis, it is that risks should never be discounted. The more clearly and accurately the risks involved in a transaction are stated, the less likely it is that values will be distorted and hence that resources will be misallocated.

The main violation of ethical

standards resulting from unsupervised transactions is not so much misallocation of resources as misapplication of the rules of the game among operators. Those who are licensed to represent both sides in a transaction are in a position to set much lower costs than anyone else, by minimizing the risks involved - not because they are actually able to reduce them, but because of a natural tendency for their interests as sellers to interfere with their decisions as buyers.

Lack of accountability

In the opening years of the twenty-first century, i.e. before the current crisis, the real level of risk accepted by the financial sector became exorbitant. Using a vast array of dazzling instruments, financial institutions (and companies acting as such) devised more and more ways of making highly risky offers to investors. During this period, according to sources in the sector, 'anybody who could fog up a mirror could borrow money'. The results are now only too evident: numerous projects were financed at an unacceptable level of risk, and the risks were seldom properly monitored. Countless debts had to be written off, and the executives directly responsible for approving the loans were not held accountable for the monetary consequences.

This scenario was largely due to the fact that the salaries and bonuses paid to the managers responsible for authorizing such financing did not depend on the performance of the se-

Le fait que les responsables du financement de ces projets n'encouraient aucune sanction les a poussés, inconsciemment peut-être, à sous-estimer l'importance des risques impliqués. C'est là le quatrième type de comportements non-éthiques.

Les quatre pratiques mentionnées ci-dessus n'ont pas seulement sapé la confiance des individus envers le secteur financier dans son ensemble, mais elles ont également détruit toute confiance entre les acteurs du secteur eux-mêmes.

Ces pratiques mettent en péril le respect des règles existantes.

curities issued by their companies or the instruments on which loans were based. Such lack of accountability - which is the key issue here - is not in itself unethical. Even if executives who approve loans are not exposed to monetary penalties, their behaviour is perfectly ethical as long as they act with due caution and care.

Nevertheless, the fact that those responsible for financing projects were not subject to penalties led them, even unwittingly, to underestimate the scale of the risks involved. With market liquidity at its height, the temptation to offer instruments that allowed excessively risky projects to be financed was simply too strong to resist. Finance thus became available to agents, principals and entrepreneurs whose profiles and ideas would not normally have qualified for it. In reality, the agents who provided it were unethically committing their companies' resources at lower prices than the risks involved in the various projects would normally have demanded.

Damage to the credibility

The four above-mentioned pro-principal unethical practices not only undermine public confidence in the financial sector as a whole, but they also destroy trust between players within the sector.

The omission of values on company balance sheets and the use of subsidiaries to avoid penalties or tax clearly undermine respect for the existing rules. Both practices violate accepted standards on such matters

as tax liability and transparency of corporate finance. They therefore run counter to public expectations that every sector of the economy will comply with socially agreed standards of behaviour. At the same time, they destroy one of the preconditions for trust among financial players and institutions, which is that players in the sector must observe the social conventions on which the rules of the game are based.

On the other hand, the unsupervised transaction clearances and the fact that project managers cannot be held accountable for losses are not in themselves direct violations of accepted standards. Nevertheless, they do damage the credibility of the financial sector by creating situations in which agents will unconsciously tend to behave in socially unacceptable ways. In dealing with conflicting interests, all such agents will tend to underestimate the risks and costs arising from prudent management of the transactions entrusted to them. If unsure whether a particular decision will be made, and in the hope that it will not be, the general public and others involved in the financial sector will tend to give agents the benefit of the doubt - hardly a basis for reliability.

A profitability artificially distorted

The four above-mentioned kinds of pro-principal unethical behaviour have one feature in common: a deliberate intention to distort relative prices within the economy. Corpo-

Tous ces comportements contraires à l'éthique ont un point commun : une intention délibérée de fausser les prix relatifs, au sein de l'économie.

Davantage de ressources sont ainsi engagées dans des activités purement financières, tandis qu'un volume inférieur de capital est orienté vers des projets d'investissement de l'économie réelle.

À mesure que les risques impliqués s'uniformisent, la confiance chez les créanciers, les débiteurs et les intermédiaires s'amenuise.

rate balance-sheet omissions and the use of subsidiaries to avoid monetary obligations artificially inflate the market value of certain companies. The fact that some operators are unsupervised and that executives' incomes do not depend on the decisions they make will, as we have seen, artificially reduce the values of certain transactions to below what they would be if the risks were properly accounted for.

The basic function of the financial sector is to channel savers' funds towards players whose need for capital, for various reasons, exceeds their present supply of it. There is an optimum state of equilibrium between the minimum that savers are willing to accept in return for lending the capital they have accumulated and the maximum that investors are willing (or able) to pay for the capital they borrow.

When the profitability of certain transactions is artificially distorted, more resources are committed to purely financial activities. This means that less capital is channelled towards investment projects in the real economy, such as capital goods or research into agricultural productivity. One symptom of this is that financial operators rapidly grow rich, despite - or even at the expense of - stagnating or slower-growing incomes in other sectors.

This therefore reduces public confidence in financial institutions, since their activities have been visibly extrapolated and their dividends, which should normally be propor-

tional to those earned in the real economy, are in fact growing much faster than the rest.

Partly because of these unethical practices, excess liquidity in the financial sector not only undermines society's faith in the sector, but also destroys trust among financial players. As the risks involved become more and more evened out, trust among creditors, debtors and intermediaries is eroded.

Market risks and values are evened out

The effect of pro-principal unethical behaviour is to minimize the losses or costs normally faced by companies or investors that seek to comply with ethical standards. The market value of unprofitable companies then approaches that of more cautious ones, and the risks inherent in aggressive transactions appear much the same as in more conservative (but less profitable) ones.

Shrewder market analysts consider this process artificial, misleading, and damaging to the reliability of the financial sector, for there is little way of knowing which companies' market value is attributable to improved performance and which to massaged balance sheets or illegal use of subsidiaries to avoid certain costs, or which transactions involve less risk by their very nature and which have had their risks artificially reduced. In such an atmosphere of uncertainty and distrust, if just

one major investor suddenly backs out, a wave of panic may spread among the rest, bringing much of the financial system to its knees.

Restoring credibility through ethics

The main thrust of this essay is that ethical professional behaviour is not only a virtue in itself, but also provides a way to restore society's faith in financial institutions and trust within the sector itself. Recently, with liquidity at historical levels, countless operators in leading financial markets came up with the most surprising ways of generating exceptionally high returns for their principals. Even though some of these offers did not violate accepted standards of professional conduct, many of them clashed with the demands of common-or-garden ethics. The cumulative impact of such unethical behaviour on the credibility of the financial sector, and on trust within it, was evident from the rate at which investors liquidated their assets in the second half of 2008.

This paper has discussed a number of unethical practices - supposedly 'win-win games' yielding exorbitant profits for both agents and principals - that have helped to destroy confidence in and among financial institutions. It has also looked at the ways in which such operations have contributed to the collapse. What now remains is to suggest ways of discouraging such practices, or at least cushioning their impact on the credibility of the sector.

The recipe proposed here focuses on expanding the notions of transparency and accountability and their application in the financial sector.

Naturally, the more transparently financial companies and institutions operate, the less likely it is that doubts will arise as to their activities or their compliance with ethical principles. Arrangements such as the extraordinary levels of bank secrecy provided by some countries, and the right of certain bodies not to disclose the nature or value of some of their financial operations, help to reduce transparency and increase distrust between major financial players, as well as in the eyes of society as a whole.

Provide financial players with proper information

Obviously, legislation requiring a higher level of transparency on the part of financial institutions and other bodies that engage in financial activities would be in the interests of every country's tax authorities. Such statutory disclosure requirements for financial operations would encourage compliance with ethical standards and help restore trust among players in the sector, as well as society's faith in it.

It would therefore be a good thing if all the information about every company's financial operations were to be published, rather than just information concerning taxable sums. Such operations would be subject to scrutiny by the market, allowing it

Un comportement professionnel éthique n'est pas uniquement une vertu en soi, c'est également un moyen de restaurer la confiance de la société envers les établissements financiers et au sein même du secteur.

Il serait bon d'imposer que toutes les informations relatives aux opérations financières des entreprises soient publiées.

Et ce, afin que les acteurs de la finance aient accès aux informations dont ils ont besoin pour connaître à tout moment les activités des sociétés et les risques associés.

La responsabilisation est un outil essentiel pour augmenter l'efficacité des opérateurs et des sociétés.

Si l'on veut responsabiliser les comportements sur le long terme, il faudrait prévoir, en amont, des incitations pour pousser les acteurs de la finance à agir en ce sens, plutôt que de leur demander uniquement de rendre des comptes après coup.

to determine, for its own purposes, whether the risks inherent in a given transaction have been underestimated (and, if so, what the probable reasons are); whether the activities of a given subsidiary are legitimate or merely serve the questionable interests of the parent company; or whether the omission of certain costs is justified or is simply a manoeuvre designed to inflate a company's market value; and to draw whatever other conclusions it sees fit.

The purpose of this would be to provide financial players (as well as other interested parties within society) with the information they need in order to keep abreast of each company's activities and the risks it has incurred. This would enable players to place their trust in institutions confidently, rather than just blindly follow the findings of a handful of leading players, based on imprecise reports about key financial transactions.

Incentives to act ethically

Accountability is an important tool for increasing the efficiency of operators and companies, and its role in ensuring compliance with ethical principles should not be underestimated. If the operators responsible for each observable element of the process are actually exposed to penalties, the means used to make exceptional profits will also be subject to scrutiny. They will then be less likely to resort to practices which do not violate accepted standards but are nonetheless unethical, simply for their clients' benefit.

To tackle the fourth above-mentioned kind of pro-principal unethical behaviour, one proposal often made in the media is to tie managers' bonuses and salaries to the performance of the securities issued by their companies. Those responsible for issuing loans will then have a strong incentive to assess the risks inherent in each proposal carefully, since these may do serious damage to their company's position.

One fundamental economic axiom is that people respond to incentives. One way to ensure accountable, responsible behaviour in the long term would be to give players incentives to act that way, rather than merely call them to account after the event. This will mean looking closely at financial operators' personal motives, as well as supervising their activities properly.

Corporate cultures that set out to make employees' personal ambitions coincide with company goals undoubtedly tend (assuming that both are legitimate and ethical) to encourage ethical decision-making. Executives who feel they are part of a team whose work takes account of and helps them attain their own goals will be more inclined to take responsibility for what they do, and hence more likely to work more diligently.

To ensure proper supervision of compliance with ethical standards, under a system of duly attributed accountability, companies can also make use of incentives aimed at the relevant players. One such instru-

Il reste beaucoup à parcourir pour restaurer la confiance chez les créanciers, les débiteurs et les opérateurs financiers. Le chemin promet d'être long et sinueux, mais c'est un voyage qu'il est nécessaire d'entreprendre.

ment would be to distribute the penalties imposed for violations of the rules, or for loss of market value, among all the members of the department responsible. Although this may create a climate of hostility and suspicion within each department, it will also give all the players involved the same incentive to find ethical solutions to dilemmas faced by their colleagues.

A long road ahead

Although the links between ethical behaviour and credibility are obvious, the task of analysing how both can be achieved more (or less) effectively is almost endless. This paper has described how, in the midst of the present crisis, failure to comply with ethical standards - and the

resulting lack of credibility - have reached a critical point. The new systems of financial regulation that are now being set up will certainly take account of the need to guarantee ethical behaviour, in the interests of greater predictability and credibility among financial players.

For the time being, the public's focus on every last detail of government plans to bail out financial institutions goes to show just how low the sector's reputation has now sunk in society's eyes. The road towards restoring confidence among creditors, debtors and operators will be long and winding, but it is a road that must be travelled. However, the task of consolidating ethical behaviour in a sector that is currently in such desperate need of public funding is proving just as hard. •

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