Ethics: A Diet For Highly Leveraged Financial Markets

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Winner of the Global Prize

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EN The most urgent issue to be addressed today is the ethical dimension of the recent failure of financial markets. The financial sector is characterised by high-leveraged investment, excessive risk taking, technological change and fast globalisation. According to standard economic theory, the role of financial markets is to allocate available resources to their most productive use and to redistribute and allocate risks and through this channel contribute positively to the economic growth. Against this backdrop, we argue that we should take a consequentialist approach. We should judge the financial markets by their ability to contribute to the human flourishing (Aristotelian eudaemonia) by performing their functions efficiently. To achieve this goal, financial markets require a multi-dimensional treatment called DIET: Debate / Incentives / Education / Targeting. Debate/ Education is to promote virtuous behaviour among market participants; "Incentives" to curb excessive risk taking and "Targeting" to allocate properly risk and resources.

FR La question la plus urgente à traiter aujourd'hui est la dimension éthique de la récente débâcle des marchés financiers. Le secteur financier est caractérisé par l'existence d'un haut effet de levier des investissements, par une prise de risque excessive, par le changement technologique et par une globalisation galopante. Selon la théorie économique standard, le rôle des marchés financiers est d'allouer les ressources disponibles pour leur utilisation la plus productive et de redistribuer et de répartir les risques, et à travers ce canal de contribuer positivement à la croissance économique. Dans ce contexte, nous soutenons que nous devrions adopter une approche conséquentialiste. Nous devrions juger les marchés financiers par leur capacité à contribuer à l'épanouissement humain (eudaimonia aristotélicienne) par l'exercice de leurs fonctions d'une manière efficace. Pour atteindre cet objectif, les marchés financiers ont besoin d'un traitement multi-dimensionnel appelé DIET: Débat / Incitations / Education / Targeting ou Ciblage. Le Débat et l'Education consistent à promouvoir un comportement vertueux parmi les acteurs du marché; les «Incitations» cherchent à freiner la prise de risque excessive, et le « Targeting ou Ciblage » consiste à répartir adéquatement les risques et les ressources.

"Men often, from infirmity of character, make their election for the nearer good, though they know it to be the less valuable."
J.S. Mill, Utilitarianism

Au cours des dernières années, l'accent a été mis sur les discussions liées à l'éthique et à la finance qui ont été une conséquence naturelle de l'investissement à haut effet de levier et à la prise de risque excessive par les banques, éléments parmi les causes de la crise financière de 2007-2009.

La problématique la plus urgente à aborder est la dimension éthique de la récente débâcle des marchés financiers et de savoir dans quelle mesure la théorie pourrait être pertinente dans la conception des marchés financiers de demain.

In the recent few years the emphasis in the discussions relating to ethics and finance has been a natural consequence of the high-leveraged investment and the excessive risk taking by banks, which were among the causes of the financial crisis of 2007 - 2009. The prevailing sentiment was that the financial system was on the verge of collapse and the subsequent efforts of central banks, financial regulators, governments and other market participants have been focused on designing a new framework to increase the stability of financial markets. As Lehman pointed out in 1988, the mechanisms of financial intermediation create "the majority of interesting philosophical questions about corporate capitalism" largely because financial institutions accumulate and manage particularly large funds and require the participation of increasingly sophisticated intermediaries. Against this backdrop, it is not surprising that among the vast array of topics in financial ethics, the most urgent issue to be addressed is the ethical dimension of the recent failure of financial markets and to what extent ethical theories might be pertinent in designing the financial markets of tomorrow.

Preliminary remarks

One of the main caveats in the discussion about the failures of contemporary finance is that participants speak different languages. Nielsen (2010) highlights that many modern economists "separated the study of economics, evolutionary forms of capitalism, and structurally related ethical issues, such as «monopolistic practices» from ethical judgements about those issues". It became a rule rather than an exception to present economic models in the form of elegant mathematical equations without mentioning ethical dilemmas, even on the list of omitted topics. At the same time, as Haakonsen (2002) put it, in a brilliantly concise formula, "modern moral philosophy is primarily the hunt for a universally normative doctrine". For an economist not overly acquainted with the history of ideas, the question "what is ethical finance?" is far from being trivial. On what grounds can we base the "ethical judgement" of financial markets? Shall we adopt a deontological or teleological perspective? Can we ignore the fact that the perception of finance has varied across the centuries largely due to the amalgamation of social practices and religious views?

Nielsen (2010) souligne que de nombreux économistes modernes « ont séparé l'étude de l'économie, les formes évolutives du capitalisme, et les questions structurelles liées à l'éthique, telles que les « pratiques monopolistiques » des jugements éthiques sur ces questions ».

Sur quelles bases peut-on fonder le « jugement éthique » des marchés financiers ?

A useful formula to overpass this conundrum is to begin with underlying assumptions that will be simple enough and acceptable for the largest possible audience. Two essential elements of Aristotelian virtuous ethics seem to carry a noteworthy common denominator: happiness or human flourishing (eudaemonia), as the ultimate goal (telos) of human actions, and the definition of happiness according to certain virtues. It is worth highlighting that Aristotle considered that virtues need to be exercised. In this respect, virtues can be compared to skills: one cannot acquire them only by following a class or reading books. To become a skilful car driver one must drive a car on the streets.

Deux éléments essentiels de l'éthique vertueuse aristotélicienne semblent porter un intéressant dénominateur commun : le bonheur ou l'épanouissement humain (eudaimonia), comme le but ultime (telos) des actions humaines, et la définition du bonheur selon certaines vertus.

Although not completely free of legitimate criticism [1], this dual perspective of telos/virtues will guide us through the rest of the text.

Another question that needs to be addressed is the nature of the contemporary financial sector. According to Biais, Rochet and Woolley (2009), technological change and inflow of resources and skilled workforce, together with market liberalisation, enabled creation of new techniques (securitisation) and new strategies (hedge funds, private equity funds), which deeply transformed the industry. Nielsen (2010) advocates the idea that high leverage is a major characteristic of today's financial landscape. In addition, one must think about the pace of globalisation of the financial sector, which matches, if not outperforms, the pace of trade globalisation. It has certainly contributed to the spread of

Les changements technologiques, l'apport de ressources et de main-d'œuvre qualifiée, couplés à la libéralisation du marché, ont permis la création de nouvelles techniques (titrisation) et de nouvelles stratégies (hedge funds, private equity funds), qui ont profondément transformé le secteur financier.

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1. According to Schopenhauer "It is Kant's great service to moral science that he purified it of all eudaemonism". The attempt made by the Ancients to prove that virtue equals happiness, "was like having two figures which never coincide with each other, no matter how they may be placed". ("The Basis of Morality").

risk across the world; but while previously, the consensus was that this process would help manage the risks and losses, it appeared that globalisation was the nexus that transformed local financial turbulences into a global one.

I find it appropriate to elaborate on the groundwork of ethics in finance because we believe that too often the public tend to deal with problems as they surface, i.e. by focusing on the scandals related to fraud and deceit without paying too much attention to the increasingly complex nature of financial markets and their role throughout history.

La seule approche réaliste pour juger les marchés financiers est téléologique : les marchés financiers contribuent d'une manière positive à la société lorsqu'ils fonctionnent correctement et efficacement.

In the remainder of the paper, I argue that the only realistic approach to judge the financial markets is teleological: financial markets contribute to the positives of life when their functions perform correctly and efficiently. Purely deontological ethics have never been applied into finance. We live in a world of regulations and compliance. I therefore outline a simple framework aiming at improving the functioning of financial markets by fostering financial markets' stability. At the same time, simply complying with regulations is not sufficient to develop virtuous behaviour. I will argue that all market participants should engage in a dual process of education (due to high rates of financial illiteracy in the society) and dialogue over the division of the financial industry in contributions to the common good. I am aware that this analysis shall apply mainly to developed countries even though some conclusions may be relevant for emerging countries as well.

Tous les acteurs du marché doivent s'engager dans un double processus d'éducation (en raison du taux élevé d'analphabétisme financier dans la société) et entamer un dialogue sur la division du secteur financier et sa contribution au bien commun.

Incentives versus moral motivation

The famous answer of James Tobin is that economics, in one word, is about incentives. Relatively early, economists developed the idea of homo economicus and tried to understand what forces drive his behaviour and motivate his choices relating to work, consumption, and leisure. In the vast majority of economic models it is assumed that individuals are self-interested and they behave as if they were maximising a certain utility function under existing constraints. This echoes a simplified version of utilitarian ethics, as advanced by J.S. Mill. There are, of course, models aiming at understanding altruistic behaviour, models stressing imperfect information of the economic agents and a plethora of other deviations from the homo economicus ideal-type. There have been even attempts to include Kantian ethics into formal economic reasoning but without too much impact[2]. However in

Dans la grande majorité des modèles économiques, il est supposé que les individus sont égoïstes et qu'ils se comportent comme s'ils maximisaient une fonction d'utilité sous certaines contraintes existantes.

2. Laffont (1975) established a utility function in which an individual maximises its utility according to the Kantian principles (act as if you wished that your actions become a universal law). White (2004) argues that homo economicus

general, economic models ignore the question of moral motivations behind agents' decisions.

Moral motivation

The following moral motivations according to three major schools of thinking about ethics; Aristotelian theory of virtue, Kantian deontology and utilitarianism of John Stuart Mill, were investigated by Colle & Werhane (2008). They found that Aristotle and especially Kant asserted that the moral motivation must unavoidably stem from intrinsic motivations of each individual. On the other hand, Mill asserts two options, the individual is motivated by the need to satisfy external requirements or it abides to internal motivations; he undoubtedly assigns moral superiority to the latter. Aristotle, Kant and Mill agree also on the fact that human life has an aim (although they differ when it comes to defining this aim), which implies that a human being must use reason in order to be capable to understand this ultimate goal.

Moral motivations in the ethical system are the equivalent of incentives in economics and in both cases one must assume that individuals are endowed with some form of reason. If we try to apply this to financial markets, one should immediately see that we face here an intellectual conundrum. How can a balance be met between authorities implementing a system of surveillance and punishment in order to obtain "ethical" behaviour from the market participants with the need for an intrinsic moral motivation behind human acts?

Clearly, compliance with rules and regulations is not enough to establish whether an act is ethical or not. In particular, within the Kantian perspective this is not only insufficient but is insignificant as to whether we abide by the existing law or not. Kant would argue that a merchant (or a banker) that applies a fair and equal treatment to all its clients because he knows that this will achieve optimum behaviour and being unlawful would be harmful for his business does not act morally. Only good will can be discerned as good, without restrictions. We believe we do not risk too much by stating that contemporary finance authorities would never rely solely on the faith that financiers will follow Kant's categorical, imperative or Aristotelian virtuous ethics.

Today, no one seriously questions the idea that markets are imperfect and need corrections in certain areas or circumstances. Many people are calling for more and/or better incentives for the market participants. In reality, various institutions are in charge

Cependant, les modèles économiques ignorent en général la question des motivations morales qui se trouvent derrière les décisions des agents.

Aristote, et en particulier Kant, ont affirmé que la motivation morale doit inévitablement venir des motivations intrinsèques de chaque individu. D'autre part, Mill avance deux options: l'individu est motivé par la nécessité de satisfaire aux exigences externes ou il suit ses motivations internes; Mill attribue sans doute une supériorité morale à cette dernière.

Les motivations morales dans le système éthique sont l'équivalent des incitations en économie.

Comment trouver un équilibre entre les autorités au moment d'implémenter un système de surveillance et de punition afin d'obtenir un comportement « éthique » de la part des acteurs du marché avec la nécessité d'une motivation intrinsèque morale derrière les actes de l'être humain ?

De toute évidence, le respect des règles et des règlements n'est pas suffisant pour établir si un acte est moral ou non.

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can follow imperfect duties but firstly, he does not attempt to model it and secondly he substantially weakens Kantian ethic theory.

En multipliant les restrictions et l'augmentation des organes de contrôle, nous entravons le développement du caractère vertueux, mais en revanche nous admettons que la supervision peut potentiellement mieux nous rapprocher de l'objectif, qui est un meilleur fonctionnement du marché financier.

Ce qui reste à trancher est de savoir selon quelles catégories exactement devrait-on juger les marchés financiers ?

Il ne faut jamais oublier que, conformément à l'économie conventionnelle, le rôle des marchés financiers est d'allouer les ressources disponibles pour leur utilisation la plus productive.
Un autre rôle, moins souligné mais tout aussi important, est de redistribuer et d'allouer les risques de ceux qui ont une aversion au risque vers ceux qui peuvent les gérer.

of regulating and controlling financial markets[3]. By multiplying the restrictions and increasing supervisory bodies we are hindering the development of virtuous character but in contrast we admit that potentially better supervision may bring us closer to the objective, which is better functioning of the financial market. This approach could be classified as teleological since it favours the assessment of the behaviour with reference to its goals. However, what remains to be determined is by which categories exactly should we judge financial markets? This requires a short enquiry into the roots and history of the financial industry.

Teleological approach – how to judge financial markets?

It should never be forgotten that according to conventional economics the role of financial markets is to allocate available resources to their most productive use. Another role, less emphasised but equally important, is to redistribute and allocate risks from those who have risk-aversion to those who can manage risks. But the extent to which it was understood is questionable. Many people claim that human misery and degradation are caused by financial institutions and not by lack thereof. The Church's ban on charging interest beyond the principal value of a loan (usury) is symptomatic of some prejudices about finance. Interestingly, the condemnation of excessive interest fostered by Dominican and Franciscan friars in XIIIth century began with a period of sharp rise in interest rates, due to increasing money supply. The latter was a direct consequence of the discovery of new silver mines in Germany (Mews & Abraham, 2007). Eventually the ban was never rigorously applied because of many exceptions being approved. Investment in partnerships and early forms of joint ventures and profit sharing were not forbidden. Neither was charging penalties for late repayments of the principal. St. Thomas Aquinas had already a vague understanding of credit risk when he accepted that there might be limited legitimate compensation for potential loss to capital incurred by the lender (Mews & Abraham, 2007). But the idea that, for example, a lender might charge the borrower because of the opportunity cost[4] of not investing in a partnership, in land or in commerce proved to be too controversial for the majority of XIIIth century theologians (Munro 2002). The consequences were devastating especially for the poor, who were obliged to turn to small, unofficial lenders, "loan sharks" in today's terminology, who were

3. Still, many people are frightened by globalising financial market mainly because, as Paul Krugman once put it, "it epitomizes what they dislike about markets in general: the fact that nobody is in charge".
4. Interesse – which was a root of word "interest" and was derived from Latin by jurists in Bologna

charging exorbitant interest (perhaps a risk premium for living under the constant threat of God's punishment).

It emerges from this brief description that critics of usury could hardly accept the existence of specialised financial intermediaries while they were favouring investments in business projects and profit sharing. More generally, the hostility towards financiers across the centuries of our history was rooted, as shown by Ferguson (2009), "in the idea that those who make their living from lending money are somewhat parasitical on the "real" economic activities of agriculture and manufacturing." The "Financial History of the World" by Ferguson offers a compelling description of how the invention of banks contributed to the cultural and economic flourishing of Northern Italy in the late Middle-Ages, how the invention of the stock exchange and central banking fostered the rise in trade and military power of the British Empire and how in general, countries that are now among the richest in the "Western World", were those which developed banking, insurance and corporate finance systems relatively early. Certainly, it would be simplistic to assume a linear relation between the pace of financial innovation and development, however, the vast majority of academic economists agree that there is a statistically significant and positive correlation between the development of the financial system and the pace of economic growth (for an excellent review see Levine 1997).

Plus généralement, l'hostilité envers les financiers à travers les siècles de notre histoire trouve son origine, comme le montre Ferguson (2009), « dans l'idée que ceux qui gagnent leur vie en prêtant de l'argent sont un peu des parasites au sein des « vraies » activités économiques d'agriculture et d'industrie ».

Certes, il serait simpliste de supposer une relation linéaire entre le rythme de l'innovation financière et le développement, mais la grande majorité des économistes universitaires sont d'accord qu'il y a une corrélation statistiquement significative et positive entre le développement du système financier et le rythme de la croissance économique.

Instability and Stability

We tend to forget all of this during the periods of financial turbulence when we paradoxically think that finance is a source of instability rather than stability and innovative financial products are weapons of massive destruction. There are some easy explanations of this phenomenon. The financial crisis of 2007-2008 caused massive job losses and deterioration of the quality of life for many people. But what we also know is that financial markets have always known booms and busts, as did emerging economies on all continents. Crises, defaults and recessions occur on a regular basis, as showed in the influential book by Reinhart & Rogoff. Banks, monetary institutions and governments tend to believe that due to better-informed policies, enhanced management tools, technical progress and many other factors, they will be able to avoid past mistakes. Crises, caused by a burst of the asset bubble, are likely to repeat themselves in the future because, as highlighted by Robert J. Shiller, who wrote extensively on asset bubble formation, they are impossible to predict with accuracy.

Nous avons tendance à oublier tout cela pendant les périodes de turbulences financières, quand nous pensons paradoxalement que la finance est une source d'instabilité plutôt que de stabilité et que des produits financiers innovants sont des armes de destruction massive.

Besides, economic difficulties are also due to other factors, among which I would mention one: the unprecedented pace of growth of populations and economies. As showed by J. Sachs in his recent article "Need versus greed", the World's output grew

Comme montré par J. Sachs dans un article récent « Besoin contre la cupidité », la production mondiale est passée de 10 USD trillions de dollars en 1960 à USD 70 trillions aujourd'hui. Cela a aidé beaucoup de gens à sortir de la pauvreté.

Les financiers tous seuls ne peuvent pas aborder toutes les questions de développement auxquelles l'humanité est confrontée. Néanmoins, ils peuvent assurer une plus grande stabilité économique, et ils devraient prendre davantage conscience des enjeux éthiques dans un monde globalisé.

from USD 10 trillion in 1960 to USD 70 trillion today. It helped many people come out of poverty. As a consequence, the planet's resources and commodities (being the most striking example) are being depleted at an alarming rate. Sachs claims that in the last few years, the greed, not only of bankers, but also of the "Western countries", which consume a very large fraction of the world's resources to maintain very high standards of living, is the main culprit. What is the role of financial markets in this? Financiers alone cannot address all the development issues that the humanity is facing. Yet they can assure more economic stability and they should increase their awareness of the ethical challenges in the globalised, highly leveraged world. Ultimately, this is what they should be accountable for.

Diet for financial markets

En utilisant notre cadre dual aristotélicien telos / vertus, un régime pour les marchés financiers devrait impliquer quatre éléments constitutifs :
D ébat
I ncentives
E ducation
T argeting (Ciblage)

Using our Aristotelian dual telos/virtues framework, a diet for financial markets should involve four building blocks:

D ebate
I ncentives
E ducation
T argeting

Des structures d'incitation et ciblage adéquats des produits sont conçues pour limiter la prise de risque excessive et donc pour atteindre l'objectif d'une meilleure stabilité des marchés financiers. Dans le même temps, nous pensons que le débat et l'éducation (de tous les acteurs du marché) sont nécessaires afin de développer un comportement vertueux parmi les participants au marché.

Adequate incentive structures and proper targeting of products are designed to curb excessive risk taking and therefore achieve the goal of better stability of the financial markets. At the same time, we believe that debate and education (of all market participants) are necessary in order to develop virtuous behaviour among the market's participants. Two things need to be highlighted before going into details: firstly, I prefer evolution to revolution and we are of the opinion that financial markets need a therapy after the shock of the sub-prime crisis rather than a shock therapy. Secondly, many of these prescriptions are already being discussed and even implemented by the authorities (in particular with respect to incentives) and in those cases our proposals are intended to cherry-pick the key areas and to suggest further improvements that are deemed necessary.

Incentives

I begin with the discussion of a few necessary improvements of the regulatory framework. This section might cover a vast array of topics that we are unable to enumerate in this restrictive format. We would like to focus on some incentives pertaining to main structural issues identified earlier: very high leverage and excessive risk taking.

Set of recommendations, now known as Basel III, represent a step in the right direction, in particular in the areas of liquidity requirements. However, with regard to capital adequacy regulation, the recommendations stand halfway; they fail to address a number of critical issues that contributed to the recent crisis.

Firstly, the development of credit derivatives was used by banks to "effectively" transfer credit risk to third parties and allowed them to reduce their capital requirements. In the paper for BIS conference, Duffie (2008) argues that banks transferring credit risk have less incentive to monitor the creditworthiness of the borrower. It makes it possible to maintain larger portions of illiquid and/or very risky assets. The result of these practices was "the total amount of credit risk in the financial system to inefficient levels". Secondly, risk calibration neglects the systemic risks to which financial institutions are exposed. The domino effects of the failure of a major bank in the market were well documented during the recent crisis. Thirdly, our measures of credit and market risk are imperfect despite evidenced improvements and being stated as a statement of fact rather than a criticism. The measuring of risks stemming was inadequate, for example, from correlations of credit risks in mortgage-backed securities. Two latter arguments are advanced in a very interesting paper by Hellwig (2010). Given the above, there are legitimate doubts that new capital requirements will effectively reduce the leverage.

L'ensemble de recommandations, connu sous le nom de Bâle III, représente un pas dans la bonne direction, en particulier dans les domaines de besoins de liquidités. Toutefois, en matière de réglementation d'adéquation du capital, les recommandations sont à mi-chemin ; elles ne parviennent pas à régler un certain nombre de questions essentielles qui ont contribué à la récente crise.

Large and Complex Regulations

The solution to this would be introducing non-calibrated, crude measures of leverage in addition to current capital adequacy measures. Although Basel III initiates leverage ratios from 2013 (as an experiment), they seem to be far too prudent. A careful assessment of the economic impact of such measures must be performed first, but equity/asset ratios of 8-10% would be much more efficient in preventing bank insolvencies and costly bailouts.

La solution serait l'introduction non calibrée des mesures de levier, en plus des mesures actuelles d'adéquation du capital.

One has to bear in mind that large and complex regulations, such as Basel III, certainly have an economic impact on financial intermediation and play a key role in the development of the economy (see the study of Basel III prepared for BIS). Reducing lending capacity of banks and/or making costs for lending higher will most probably translate into an economic slow down. Critics of Basel III, like Hellwig, argue that reducing leverage, restricting moral hazards and lowering systemic risks in the financial system, will result in lower risk premiums being asked by equity investors. Thus, in fact, the increase of the cost of lending will be much smaller and the benefits in terms of system stability will be significant. This trade-off, if there is one, must be a matter of political choice.

Il faut garder à l'esprit que les règlements importants et complexes, tels que Bâle III, ont certainement un impact économique sur l'intermédiation financière et jouent un rôle clé dans le développement de l'économie.

Apart from capital regulations, the attention of the public was on the compensation levels of executives and more generally senior financiers across all sectors of the industry. The argument usually goes that it is unfair for bankers to receive large fractions of the profits when the economy is doing well but the costs of bailing out financial institution has to be borne by taxpayers (which by the way amplifies the moral hazard problem). The concern with executive pay is legitimate yet the issue that needs to be addressed is whether compensation packages offered to bankers (executives in particular) provide them with an optimum incentive structure from a risk-stability perspective. This is an unorthodox view. Cai, Cherry and Milbourn (2010) explains that from a classical perspective, the calibrating of the executive's pay scheme is "aligning managerial incentives with those of shareholders".

Le souci de la rémunération des dirigeants est légitime, mais la question qui doit être abordée est de savoir si les régimes de rémunération offerts aux banquiers (aux cadres en particulier) leur fournissent une structure d'incitation optimale d'un point de vue du risque et de la stabilité.

There are few chances for the return of Medici-style family-run banking. The principal-agency problem in the case of the financial industry is amplified by a number of factors such as an increasingly high leverage, deposit protection schemes, explicit or implicit guarantees of the State or access to emergency liquidity windows by the Central Bank. Kandel (2009) argues that executive pay might be substantially reduced without hampering the proper incentive structure. Some economists, for example, Gehrig, Lutje & Menkhoff (2009) defend the hypothesis that the relation between the size of variable, performance-based remuneration of investment fund managers and their willingness to take risk is insignificant. However, there was a general consensus that remuneration packages encourage more short-term profit maximisation, for example, by increasing leverage, engaging in aggressive trading or loosening control over credit origination standards.

Le problème d'agence dans le cas du secteur financier est amplifié par un certain nombre de facteurs tels que l'effet de levier – de plus en plus élevé –, les systèmes de protection des dépôts, les garanties explicites ou implicites de l'État ou l'accès aux fenêtres de liquidité d'urgence établis par la Banque centrale.

But the key issue is the following - if managers maximise the shareholder's utility, they do not necessarily take into account the interests of depositors, debtors and other stakeholders, not to mention the issues of general market stability. The general audience being authorised to impose on financial institutions the implementation of compensation structures that promote overall system stability is not evident. Financial stability is highly desirable and probably optimal for society as a whole but the means to achieve this goal must be debated.

What public authorities could propose is the introduction of financial stability criteria to calculate the variable part of executives' compensation. It could be recommended (but not imposed!). It is for the banks to establish internally in advance thresholds for leverage, stable funding ratios, overall market/credit risk levels and adjust the compensation accordingly if the objectives are met or not.

Les pouvoirs publics pourraient proposer l'introduction de critères de stabilité financière pour calculer la part variable de la rémunération des dirigeants. Cela pourrait être recommandé (mais pas imposé !).

Targeting

In order to perform correctly one of the major roles of financial markets, i.e. the redistribution of risks, market participants must distribute products that are adequate to the client's financial lite-

Afin de jouer correctement l'un des rôles majeurs des marchés financiers, à savoir la redistribution des risques, les acteurs du marché doivent proposer des produits qui sont en adéquation avec l'éducation financière du client.

racy (we address the issue of literacy in the subsequent chapter). The application scope of adequate targeting principle is very wide, for example, offering brokerage accounts to retail clients or extending loans denominated in foreign currency to clients having revenues in domestic currency means exposing them to risks they may not necessarily be able to manage. This is another field of financial regulation that has been subject to careful examination, and significant progress has been made. From a European angle, Markets in Financial Instruments Directive (MiFID) is one of the best examples of this. One of its key objectives is to improve the categorisation of clients according to their ability to understand financial products. Three categories apply; retail clients, professional clients and counterparties.

Ceci est un autre domaine de la régulation financière qui a été soumis à un examen attentif, et des progrès significatifs ont été réalisés. Du point de vue européen, les Marchés d'Instruments Financiers (MiFID) en sont des meilleurs exemples.

The last category encompasses other financial institutions. Let us focus on the first two that should be far more risk-adverse. The definition of a professional client is that it must have "the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs". The remaining clients are retail clients, for whom we assume insufficient knowledge to take informed investment decisions. They enjoy, at least in theory, the highest degree of regulatory protection. However, the alarming failure by banks to assess the credit risks had a direct impact on customers purchasing even basic retail banking products. Was it the fault of retail customers or the banks when in some countries people were massively granted mortgage loans they could not afford (sub-prime)? The question is rhetoric, given the massive asymmetry of knowledge and experience between the banks and the low-income borrowers. Another example is offering clients products with embedded currency risks like loans denominated in foreign currencies to people who cannot hedge the risk (they have no access to derivatives market).

Était-ce la faute des clients de détail ou des banques lorsque dans certains pays les gens se sont vus octroyer massivement des prêts hypothécaires qu'ils ne pouvaient pas assumer (subprimes) ? La question est rhétorique, étant donné l'énorme asymétrie de connaissances et d'expériences entre les banques et les emprunteurs à faible revenu.

Asymmetry of understanding

The same analysis might apply to some extent to professional clients. As a matter of fact, the distinction between professional and retail client is often blurred. Professional clients might be, for example, medium or large corporations who are clients of banks. Those firms are supposed to be managed by financially literate managers who are able to identify and tackle potential risks but the reality is somehow different. In 2008/2009, when the markets were nervously selling assets in the emerging markets, pushing their currencies down, sometimes dramatically, one of the key topics in Poland were currency options. It appeared that Polish companies had entered into currency options with banks without necessarily having any underlying transactions to hedge and bet against apart for the appreciation of the Polish currency. In many cases the purpose of this was purely speculative and it exposed companies to severe losses. The line of defence for banks was that they were dealing with professional clients. Yet in a number of testimonies to the press, both employees of the banks and clients confirmed that companies which purchased the products were not sufficiently aware of the risks they were taking. The line between unethical behaviour and poor business decision is often very thin but in this case the structure of incentives was clearly inadequate. Bank employees had strong incentives to sell because their final salary depended on the volume of products sold, so they were emphasising to clients only the potential gains.

La ligne entre les comportements contraires à l'éthique et une mauvaise décision d'affaires est souvent très mince, mais dans ce cas, la structure des incitations était nettement inadéquate.

An alternative approach is to amend the structure of incentives in order to promote better targeting of financial products. There are no easy solutions to this problem but financial institutions should be encouraged to take a more conservative approach when assessing the ability of the client to manage risks. From a regulatory perspective, the incentives might come from financial services authorities. A good example was the reaction of the Polish Financial Authority (KNF) to the widespread practice of lending in foreign currencies to retail clients. According to "Recommendation T" banks must perform stress tests of the borrower's ability to service its debt under the scenario of a shift of interest rate and foreign exchange rate depreciation. It also recommends a threshold of debt repayment expenses in relation to monthly net income. Although stress testing is imperfect, implementing these measures is a relatively easy way to improve adequate targeting of financial products.

Il n'y a pas de solutions faciles à ce problème, mais les institutions financières devraient être encouragées à adopter une approche plus prudente au moment d'évaluer la capacité du client à gérer les risques. Du point de vue réglementaire, les incitations pourraient venir des autorités financières.

Debate / Education

These two elements are presented together because there are some obvious synergies to be achieved between the two. Debate on the ethical issues in finance should take place within the financial institutions but also in the public realm and involve all types of social actors. One of the latent effects of such a debate will be an increased awareness of ethical issues within society.

Le débat sur les questions d'éthique en finance devrait avoir lieu au sein des institutions financières, mais aussi dans le domaine public et devrait impliquer tous les acteurs sociaux. Un des effets latents d'un tel débat sera une prise de conscience accrue des questions d'éthique au sein de la société.

Almost every one of us are clients of financial institutions and we depend on them to satisfy our basic needs. As echoed by R. Hinde (2007), when the competition mechanisms on the market work correctly, "the ethical demands of the public can affect what the firm does". Naturally, how much the firms are changing their behaviour depends to large extent on how many customers are aware of the ethical issues and whether they decide to take direct action. Some critics would also say that this is inscribing ethical necessity into the logic of market competition. However, I believe that this is a necessary step to develop virtuous behaviour, which in the future will stem more from intrinsic moral incentives rather than regulatory or market constraints.

One of the key constraints is the relatively low financial literacy of the society. Lusardi (2008) made a very convincing case about the current level of illiteracy, highlighting that ignorance of basic financial concepts may be linked to poor savings level (including pension savings), inadequate borrowing decisions and lack of participation in more sophisticated forms of investment. Against this backdrop, taking informed decisions is very difficult. To address this issue I propose the following. Fundamentals of finance and economics should be introduced into high schools at a relatively early stage as a mandatory subject. The objective of this would be to provide all students with a basic knowledge of financial products that they are most likely to come across as adults (savings accounts, mortgage loans, pension plans, insurance etc.).

At the same time financial institutions also should engage in a programme of education for their employees, which should not be limited to basic e-learning programmes with the Compliance department. One day of the year should be proclaimed as a “Day of Ethics in Finance”. The key feature of the “Day of Finance” would be that it must be prepared in advance. Employees should form working groups and research selected topics in ethics, which should involve the study of classic texts and the analysis of market practices. The results would be presented on the “Day of Finance”. Other tools could be developed internally by companies which should be given a flexibility to adapt this exercise to their specific internal characteristics.

Administratively, the “Day of Finance” could be co-ordinated by Central banks or financial authorities; it should not be imposed on financial institutions but rather recommended as good practice. In addition, Central banks could put additional pressure on other banks by organising a series of seminars, lessons at schools or advertising campaigns. An integral part of the “Day of Ethics” should be a “round table” debate organised, for example, by national broadcasting companies and well advertised among the public, where different social partners might debate ethical issues. The main objective of the round table would be to promote discussion in an attempt to build a common language with regard to those issues. One of key topics should be the responsibility of the financial industry to promote sustainable economic growth.

Les connaissances relativement faibles en finance de l’ensemble de la société sont l’une des principales contraintes.

Dans ce contexte, la prise de décisions éclairées est très difficile. Pour aborder cette problématique, je propose que des fondements de finance et d’économie soient introduits dans les écoles secondaires à un stade relativement précoce comme matière obligatoire.

Dans le même temps, les institutions financières doivent aussi s’engager dans l’éducation de leurs employés, car celle-ci ne devrait pas être limitée à des programmes basiques de *e-learning* organisés par le département de conformité. Un jour de l’année devrait être proclamé comme étant la « Journée de l’éthique en finance ».

Les employés devraient former des groupes de travail et faire des recherches sur des sujets choisis sur l’éthique, ce qui devrait impliquer la lecture de textes classiques et l’analyse des pratiques du marché. Ce travail de groupe devrait être exposé au cours de la « Journée de l’éthique en finance ».

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