

# P<sup>rimum non nocere</sup> (first do no harm): can the principles of medical ethics be applied to finance?

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\* The views expressed herein are those of the author and do not necessarily reflect those of the Organization he is affiliated to.

Ethics can be defined as the principles that govern a person's or a group's behaviour. Normative ethics is the branch of ethics concerned with what makes an action right or wrong.

Finance professionals frequently face ethical decisions and questions of right and wrong, and must constantly balance risk versus reward and outcomes for clients, the firm and themselves. Recent events suggest that the finance industry has not been getting these ethical decisions right. We are currently experiencing a financial crisis on an unprecedented scale, worldwide growth has stalled, governments are printing an extraordinary amount of money, and confidence in finance professionals is at an all-time low. Record fines have been paid by banking institutions for offences ranging from mis-selling of derivatives and fixing of interest rates to manipulation of

commodity markets. The proliferation of peer-to-peer lending sites, cooperatives and credit unions demonstrates consumers' wish to move away from the financial companies they no longer trust.

If the finance industry is getting it wrong, who has been getting it right? With politicians cheating on their expenses, journalists tapping private phone lines and even our sports heroes turning out not to be who we thought they were, who is setting the right example?

An Ipsos Mori poll conducted in the UK in 2013 found that physicians were the most trusted profession, with 89% of respondents saying that they would trust physicians to tell the truth. The figure for bankers was just 21%; more worryingly, it had fallen from 29% in 2011. Trust in financial professionals is being eroded.<sup>1</sup>

<sup>1</sup> Ipsos Mori, *Trust in Professions*, 2013 and 2011.

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Les professionnels de la finance doivent constamment trouver un équilibre entre le risque et la récompense, les revenus pour les clients et ceux pour l'entreprise et pour eux même. La côte de confiance des financiers est à un niveau historiquement bas.

Dans le milieu médical, qui inspire plus confiance, la question de l'éthique est beaucoup plus développée et le secteur financier pourrait s'en inspirer. Les quatre principes presents sont l'autonomie, la bienfaisance, la non-malfaisance et la justice. Chacun de ces principes sera évalué pour voir comment les financiers peuvent les appliquer au quotidien.

L'autonomie implique que les patients/clients peuvent contrôler ce qui leur arrive grâce à une communication adaptée des médecins qui respectent avant tout leurs choix. Appliqué au monde de la finance, l'autonomie implique que les banquiers s'assurent toujours de la compréhension de toute la transaction par les clients et évitent la vente abusive.

If we take this public perception of truthfulness as a yardstick for ethical behaviour, perhaps the finance industry could learn from the medical profession. In the medical sector, the study of ethics is significantly more developed than in the financial sector. A widely accepted framework for biomedical ethics is the four principles plus attention to their scope of application introduced by Beauchamp and Childress in *Principles of biomedical ethics* (1978).

The four principles are autonomy (respect for the rights of the individual), beneficence (do the most good), non-maleficence (do no harm) and justice. These four principles are deemed *prima facie*: each of them is mandatory unless it conflicts with another one, in which case we must choose which one to abide by. This framework provides a simple and understandable means of assessing moral dilemmas faced by medical practitioners. I would argue that all ethical questions can be answered with reference to these four pillars, and that this framework can be applied to other sectors<sup>2</sup> – a theory that will be tested in this paper. I will evaluate each of the four principles in turn, discussing how finance professionals can apply them to the judgments they make every day, and whether this framework is sufficient to help them make better choices. Currently, it is investment banks that bear the brunt of the criticism and are taking much of the bla-

<sup>2</sup> Gillon, R. (1994). *Medical ethics: four principles plus attention to scope*, *BMJ*, 309:184.

me for the financial crisis. This paper will therefore focus on that area of the financial world.

## Autonomy

The first principle, sometimes considered *primus inter pares*, is autonomy. This is the notion that patients have the right to control what happens to them, free of coercion or coaxing. In practice, this places an obligation on medical practitioners to fully explain to patients the benefits and potential risks of any proposed treatment, so that they can give informed consent. Physicians must be able to communicate in language that patients understand, as well as listen to patients and their concerns. The other aspect of autonomy is respect for patients. The classic case study used in medical ethics is a Jehovah's Witness who refuses a blood transfusion. The physician may believe that a blood transfusion is the most effective course of treatment, but so long as the Jehovah's Witness has understood the available options and the risks involved, the physician must respect his or her wish not to have the transfusion.

So how does this relate to the finance world? In medicine, physicians must explain the risks and rewards of medical treatment; in finance, we are dealing with the risks and rewards of complex financial products. Both scenarios involve a potentially vulnerable party relying on the advice of a person with significant influence. If we apply the au-

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Les réglementations mises en place depuis la crise ont renforcé la surveillance de l'information devant être transmise aux clients, afin que ce dernier puisse prendre une décision éclairée. Les banquiers n'ont apparemment pas appliqué cette règle, motivés par le gain de commissions lors d'opérations parfois inutiles. Le corps médical n'est généralement pas confronté à ce genre de conflits d'intérêts.

La structure d'incitation serait donc responsable des actions contre l'éthique prises par les financiers.

La notion de bien-faisance consiste à produire une action bénéfique pour les patients, en minimisant les dommages. Une information préalable basée sur une évaluation des risques est indispensable.

Avec leur rôle crucial dans l'économie mondiale, les banques ne doivent apporter que des avantages favorisant le développement global et la croissance.

tonomy principle to a financial transaction, bankers have an obligation to make sure their clients understand the transaction they will be entering into; there should not be any hidden costs or risks that the client does not comprehend.

It is also the banks' duty not to coerce their clients into buying products or entering into transactions that they do not wish to. The recent mis-selling claims demonstrate that bankers have been guilty of selling products that were not properly understood. Clients may have given their consent to these products, but it is questionable whether that consent was informed.

Regulations introduced since the crisis have tightened up supervision of the information that must be supplied to clients. One of the aims of the 2010 Dodd-Frank Act is to enhance consumer protection. Title VII of the Act provides a framework for regulating over-the-counter derivative markets. Its purpose is to increase transparency in the market and reduce systemic risks. It is the responsibility of the Commodity Futures Trading Commission (CFTC) to implement part of this framework, and in this connection it has drawn up what are known as the External Business Conduct Standards (EBCS). These place pre- and post-trade obligations on swap dealers: material economic terms and a pre-trade mid-market price must be provided to clients, and scenarios must also be supplied on request. This is to ensure that clients are aware of all

of the relevant facts so that they can make an informed decision. Bankers appear not to have abided by the autonomy principle, which this rule is designed to enforce.

Why have bankers failed to respect their clients and allow them to make informed choices? One key difference between finance professionals and physicians is the incentives involved. If bankers earn a commission on each product sold, they may be tempted to persuade their clients to enter into unnecessary transactions. Such conflicts of interest are not usually found in the medical profession, for physicians do not normally stand to benefit from their patients being treated.

In certain circumstances, however, they do; for example, private plastic surgeons are paid for each operation they perform. Indeed, the plastic surgery industry has recently been criticized for aggressive marketing techniques, insufficient advice and lack of protection for consumers. In the UK an in-depth review of some of these practices is now being conducted, and may lead to increased regulation and consumer protection.

It would thus appear that the incentive structure may be what causes professionals to act unethically. Lawmakers, too, have recognised this; a proposal to cap bankers' bonuses at 100% (or, with explicit shareholder approval, 200%) of their salaries is currently making its way through the European Parliament. We have also seen an increase in the level of defe-

Les résultats potentiels dans le domaine chirurgical peuvent être comparés aux variations potentielles qui existent dans le cas d'opérations financières avec des taux variables. La probabilité des différents scénarios dans ce secteur peut varier de manière spectaculaire et s'avérer être très défavorable au client.

La FSA a trouvé de nombreuses lacunes dans les opérations de vente de swaps aux PME. Les clients n'ont pas reçu d'informations assez éclairées pour prendre les bonnes décisions, ce qui ramène à la notion d'autonomie.

La règle Volcker prévoit, pour les banques d'investissement, l'interdiction d'avoir des pupitres de négociation pour compte propre, qui présentent des risques trop importants pour la clientèle et le système financier global.

red compensation bankers receive, designed to align bankers' incentives with those of the bank as a whole.

### Benevolence and non-malevolence

Benevolence is the notion that physicians' actions must benefit their patients. It is difficult to discuss benevolence without also considering non-malevolence. In accordance with these principles, physicians aim to produce a net benefit for their patients while minimizing any harm. In order for physicians' actions to be beneficial, they must have sufficient education and training and they must have empirical evidence that they can use to determine the benefits and risks of a course of action. Armed with this information, they can then make an educated assessment of whether the intervention is the best course of action. The autonomy principle must then be applied, so that patients can make their own assessment of the risks and rewards.

Banks play a critical role in the worldwide economy. They provide essential services to clients, ranging from simple loans and deposits to complex transactions – all of which should promote global growth and development when banks are operating correctly. I think everyone would agree that bankers therefore have an obligation to create benefits and minimize harm. With this in mind, do the benevolence and non-malevolence principles help us determine the appropriate course of ac-

tion in various scenarios? To analyse these principles, I will consider two hypothetical situations.

First, a client approaches a bank to hedge interest-rate risk on a floating-rate loan. If interest rates rise, liability increases; if they fall, it decreases. In order to hedge this risk an interest-rate swap may be entered into, with the client paying a fixed rate to the bank and in return receiving a floating rate to cover the loan interest. This would appear to benefit the client, who is locked into a fixed rate and no longer has to worry about moves in interest rates. However, if interest rates decrease after the transaction is entered into, the fixed rate the client is locked into will be higher than if the transaction had not been entered into at all.

When the transaction is first considered, neither the banker nor the client can know which way interest rates will move. In order to assess whether the transaction will yield a net benefit they must consider the potential moves in interest rates and the resulting outcome if they do, or do not, enter into the transaction. We can compare this to a physician advising a patient on the potential outcomes of surgery.

Where this differs from the medical scenario is that the likelihood of different interest rates can vary dramatically over time. If medical research has determined that the survival rate for a particular type of surgery is X%, that figure is unlikely to change between the surgery being discussed and being carried out. If the

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Une preuve supplémentaire de régle-  
ment appliquant l'implémenta-  
tion des principes de  
bienfaisance se trouve  
dans les directives  
propres à Bâle III.  
Parmi les causes de  
la crise financière  
figurent les prêts hypo-  
thécaires subprime  
originaires des Etats-  
Unis et la méthode de  
répartition des risques.

La justice peut être  
divisée en trois caté-  
gories appliquées à la mé-  
decine: la distribution  
équitable des ressources  
limitées, le respect des  
droits des individus et  
celui des lois morale-  
ment applicables.

Pour voir si les  
principes de la justice  
peuvent s'appliquer  
à la finance, il faut se  
demander si les finan-  
ciers ont des revendica-  
tions concurrentes  
auxquelles ils doivent  
allouer des ressources.  
La question essentielle  
est de savoir quand  
et où s'appliquent les  
obligations morales.

patient is comfortable with that level of risk, the surgery can take place.

However, when a client is hedging interest-rate risk, the likelihood of the various scenarios may change dramatically after the transaction has been entered into. For example, a client that entered into a ten-year GBP interest-rate swap in July 2007 would have paid a fixed rate of 5.96% in exchange for the 3-M LIBOR. Five years later, on 31 July 2012, following the financial crisis and the subsequent decrease in interest rates, the 3-M LIBOR stood at just 0.74375%; the client would be paying 5.96%, but would have paid significantly less had no swap been entered into at all. In July 2012 the five-year swap rate was 0.96%; this would mean the client would have to pay 5% in order to terminate the transaction and go back to paying the 3-M LIBOR. From this we can conclude that, although in 2007 it might have made sense to assume the transaction would yield a net benefit, in the long term the client would have been better off not hedging his or her interest rate risk at all.

In 2012, Britain's Financial Services Authority (FSA) announced that it had found significant failings in the selling of swaps to small and medium-sized enterprises (SMEs).<sup>3</sup> Barclays, HSBC, Lloyds and RBS are now going through a review process and providing redress to clients to whom these products were mis-sold.

<sup>3</sup> FSA agrees settlement with four banks over interest rate hedging products, FSA press release, 29 June 2012

The FSA found the following examples of 'poor sales practice':

- Poor disclosure of exit costs;
- Failure to ascertain customers' understanding of risk;
- Non-advised sales straying into advice.

Although in a different economic climate the interest-rate hedging might have yielded a net benefit, the FSA found that clients were not given sufficient information to make an educated decision. This brings us back to the need to abide by the autonomy principle; bankers can advise their clients on the potential outcomes and how likely those outcomes are, but must also draw attention to the fact that these likelihoods may change. Clients can then make an informed decision.

As a second example, let us consider proprietary trading desks within investment banks. Their purpose is to generate profits and create shareholder value by investing and taking risks. However, in doing so they put the bank's capital at risk, and may erode shareholder value. The Volcker Rule introduced under the Dodd-Frank Act stipulates that investment banks are no longer allowed to have proprietary trading desks. This type of speculation has been judged to pose such a risk to the financial system that it must be prohibited. The risk to customer deposits, and the potential shockwaves in the financial system, outweigh the possible benefits from proprietary trading. In the past, the banks them-

En examinant la portée du principe de l'économie, les questions philosophiques semblent moins complexes dans la finance que dans le milieu médical.

Partant du principe que les hedge funds et banques d'investissement sont experts dans leur domaine, les banques n'ont pas à considérer les principes de bienfaisance en faisant des affaires avec eux.

Les banques ont-elles l'obligation de fournir un bénéfice pour la société et l'économie globale ou doivent-elles uniquement servir les intérêts de leurs clients et investisseurs? Elles doivent en tous les cas ne nuire à aucun parti.

selves decided how much of such trading to undertake. Limits and controls were in place to monitor the level of risk being taken and conclude whether it was appropriate.

Again it would seem that regulations have been introduced to enforce banks' adherence to ethical principles. Not trusting banks to weigh up the risks and benefits properly, regulators have taken that decision away from them.

We see further evidence of regulations implementing the beneficence and non-maleficence principles in Capital Requirements Directive IV (CRD IV), part of the European Commission's implementation of Basel III. Article 122a states that investors in securitization will face punitive capital charges if the originator does not retain a 5% economic interest in the structure.

Among the causes of the financial crisis were the model whereby subprime mortgages were originated in the US and the method of risk distribution. The 'originate-to-securitize' model meant that the originator of the loan no longer cared whether or not the borrower defaulted, for once the loan was securitized the originator was not at risk. Taking this a step further, there were even situations in which the originator could stand to profit from defaults on loans through shorting of the securities the loans were packaged into. The purpose of article 122a is to ensure that the interests of the original lender and the investors in securitization are aligned.

Lenders must always have what is known as 'skin in the game'. This gives them an incentive to ensure that the products they originate and sell yield a net benefit and minimize harm, as they also risk being harmed if the products fail.

## Justice

The fourth principle, justice, can be subdivided three categories when applied to medicine: fair distribution of scarce resources, respect for people's rights and respect for morally applicable laws (Gillon, 1994).

This principle raises ethical questions about the allocation of resources. Consider an expensive new drug. Should everyone have the same access to it? How are such drugs to be allocated between competing claims? Should they be given to those that can pay the most for them, or to those with the greatest need, or should they be distributed equally?

In considering whether the justice principle applies to finance, we can ask whether financiers have competing claims to which they must allocate resources. In the context of corporate finance or investment banking, this principle does not seem relevant. Whereas in medical ethics the debate continues on whether need trumps ability to pay, in finance it appears to have been settled. Those who can pay get access to the resources. If corporations need to raise funding in the capital markets, it is simply a question of supply and demand; if they are willing to pay what the investors

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Des règlements ont également été introduits pour minimiser les éventuels dommages en renforçant la situation des fonds propres des banques. Bâle III traite aussi de la liquidité des banques en introduisant un ratio de couverture de liquidités. Les différentes mesures visent à s'assurer que les banques peuvent résister aux chocs et maintenir la stabilité du système financier.

demand, they can raise the funding. Conversely, if there are many investors wishing to buy the same bond, the investor willing to pay the highest price will be the purchaser.

### Scope

As well as the four principles, we must also consider their scope. When and where exactly do the moral obligations apply? This may seem a fairly obvious question for healthcare professionals, who have an obligation to provide benefits and minimize harm to the patients in their care. But things can get more complicated. For example, patients' autonomy must be respected – but what if the patient is a minor, or mentally impaired? At what point does a child fall within the scope of respect for autonomy?

In considering the scope of the autonomy principle, the philosophical questions that arise appear less complex in finance than in the medical world. Once provided with sufficient information, clients in the financial world should be able to make an autonomous decision. It may seem obvious that the beneficence and non-maleficence principles apply when a client approaches a bank for financial advice – but if hedge funds or other banking institutions wish to enter into a transaction, are they entitled to the same protection?

We may believe that, as market participants, investment banks and hedge funds are experts in their fields, so that banks do not have to abide by the beneficence and non-maleficence principles when doing business with

them. It is not banks' responsibility to provide them with the information that would usually be given to other counterparties, as they can determine for themselves whether they need this information – and, if so, they can calculate it themselves.

Once again we find that regulators have attempted to answer these questions for us. The aforementioned External Business Conduct Standards, drawn up to supervise the information supplied to clients, are very clear about their scope. Transactions between swap dealers and major swap participants do not fall within it.

A second question we can ask about the scope of the beneficence and non-maleficence principles is whether banks have an obligation to provide a net benefit to society and the economy as a whole – or are only required to provide a net benefit to their clients and shareholders. Throughout the financial crisis we have seen that banks are systemically important and that their actions can have dire consequences for the world economy. The phrase 'too big to fail' has entered everyday speech, and it is now widely accepted that banks have a duty to provide benefits to their clients and shareholders but, at the same time, to 'do no harm' to the economy and society as a whole.

Regulators are in agreement on this, and the aforementioned Volcker Rule is designed to prevent banks from taking risks disproportionate to the potential benefits.

Regulations have also been intro-



Chacun des quatre principes étudiés est très pertinent pour le monde de la finance, mais la question est de savoir s'ils peuvent être appliqués aux questions éthiques qui se posent dans ce domaine. Bon nombre des problèmes du secteur auraient pu être évités avec une telle application, selon les régulateurs financiers.

De nombreux règlements ont donc été mis en place, en particulier aux Etats-Unis, afin de garantir l'autonomie et la protection des clients.

Les discussions sur l'éthique progressent, on peut espérer que les débats à venir améliorent encore la situation actuelle. Abordés sous l'angle de la banque de financement et d'investissement, les quatre principes évoqués pourraient également s'appliquer au domaine de la banque de détail.

duced to 'minimize harm' by strengthening banks' capital position. Basel III, which was drawn up in 2010 and will be phased in over the next six years, increases from 2% to 7% the amount of Tier 1 capital that banks must hold; and 'systemically important financial institutions' are required to hold an additional amount on top of this. The definitions of which assets can form part of Tier 1 capital are also stricter. In addition, Basel III addresses the liquidity of banks by introducing the liquidity coverage ratio. Banks must be able to withstand a 30-day stress scenario by holding enough liquid assets to cover potential cash outflow during the stress period. The net stable funding ratio has also been established; this focuses on longer-term liquidity, measuring long-term stable funding against the liquidity profiles of the assets being funded. Capital requirements are also increased for counterparty credit risk arising from derivatives and repos. All these measures are designed to ensure that banks can withstand shocks, and to maintain stability in the financial system.

### Conclusion

Having considered each of the four principles, can these be applied to the ethical questions that face the finance world? Do they provide a framework on which we can base our decisions? I would argue that the principles are very relevant to the finance world, and that many of the issues currently facing the sector could have been avoided if these principles had been adhered to.

Financial regulators also seem to believe that these four principles are relevant and should be complied with. In the wake of the financial crisis, a great deal of effort has gone into establishing its causes – and identifying the practices that need to be stopped if we are to make our way out of it.

In assessing the four principles I have found that many of the regulations introduced, or soon to be introduced, can be directly linked to them.

In adopting the Dodd-Frank Act, US regulators have recognised that clients' autonomy is important and was not being properly respected. To address this, they have introduced regulations to protect clients and their rights more effectively. Regulations have also been introduced to make sure that in future banks do more good than harm. I will not discuss whether the regulators' actions are sufficient to achieve these objectives, but I highlight them as evidence that the four principles can provide a framework for the finance industry.

As the discussion on ethics in finance progresses, we may hope that as much thought and debate goes into it as in the field of medical ethics. Although this paper has approached the topic from a corporate and investment banking angle, I believe that the four principles could also be extended to the field of retail and consumer banking. •

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