Duties of Care and Ethical Issues in Finance

Nick Morris and David Vines

The Role of Public Policy in Delivering a More Professional Financial System

Paper to be delivered by David Vines

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Introduction

- Until three years ago the great moderation
- What went wrong had in part to do with the self-interested behaviour of financial institutions – and its significant implications
- Why this behaviour? – it is encouraged by a view of human nature thought to come from Adam Smith's *Wealth of Nations.* This view underlies Econ101
  - Competitive markets lead to good outcomes through 'invisible hand'
  - Role of regulatory policy is to correct 'market failures', as compared with this normative benchmark
- But there is another view of human behaviour to be found in Smith's *Theory of Moral Sentiments*
- And other professions have a tradition of integrity, and a code of conduct, which is based on this view of behaviour
- We seek such a policy towards finance which is based on such a view of behaviour
- Our objective is a code of conduct, both for financial institutions and for individuals in the financial sector
- The task of this lecture is to convince you than this avenue of thought has some merit, and some usefulness.

- The Lecture will have five parts
  - Microeconomics of why crises happened
  - Microeconomics of behaviour by financial firms and by financial-sector employees
  - Regulatory Failures over the last 40 years
  - The Ethics of Public Policy
  - Creating Integrity in Finance

1 The Macroeconomics of Crisis

The opening of international capital markets since the collapse of the Bretton Woods system in 1971 has led to a series of financial crises. “Boom and bust” did not go away. I will discuss four such crises

- In each case a there was a cause for optimism which led to overextended finance
  - Latin American in early 1980s – lending opportunity of late 1970s with low interest rates; Volker raised interest rates, Mexico on verge of default by 1982
  - Savings and Loan crisis of early 1980s – low interest rates, thrifts over-extended, 700 thrifts failed when Volker raised interest rates
  - Asian Crisis of 1997-98 – rapid export growth stopped in 1996/7, leveraged exporters collapsed; financial and currency crisis spread throughout Asia
  - The present crisis – during the ‘great moderation’ subprime lending enabled the poorest Americans to participate in the American dream followed by worst downturn since 1930s
- In each case there the financial system was rescued, at massive cost to taxpayer
  - Savings and Loan crisis of early 1980s – resolved at taxpayer cost of $87.9 billion
  - Latin American: ‘concerted lending’ followed by ‘lost decade’ for Latin America
  - Asian Crisis of 1997-98 – loans were securitised, required IMF lending to sovereign states which was used to repay bannks, IMF loans repaid
  - The present crisis – massive recapitalisation of banks, but not nationalisation of assets

- Earlier crises in the 19th and early 20th centuries led to reform
  - 1906-7 crisis solved by JP Morgan but led to creation of Federal Reserve
  - Great Depression led to Glass Steagall act and to other detailed regulation
- But since 1980s crises have led to led to financial rescues – and then to *further* deregulation
- This reflected a strong belief in invisible hand - that markets self correct
- … and a belief that sovereign borrowers should repay loans to avoid moral hazard
  - cf Anne Krueger and SDRM
- But this was a system in which there was extreme moral hazard operating to the benefit of the financial system
  - financial system rescued after each crisis
- But this is not an *ethical* issue. Addressing it requires macroprudential regulation
- cf Professor Spahn at ICRIER conference

2 The Microeconomics of Crisis

- Seeking to understand the business model of the firms at the heart of this boom and bust world.
- The demands of finance have increased very rapidly in the last 40 years
  - Home ownership
  - Retirement/old age
  - Health care
  - Education of children
- Note the importance of trust
- The nature of firms has changed
  - Quotation
  - See Figure 1

Figure 1

Investment Banks

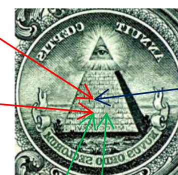
- High Margins
- Volatile

- **Markets**
- Unlimited Supply

- **Deal Making**

Commercial Banks

- Relationship
- Low margins
  - Cyclical
- Scale



Retail Banks

- Assembly Line
- Low margins
  - Stable
- Scale

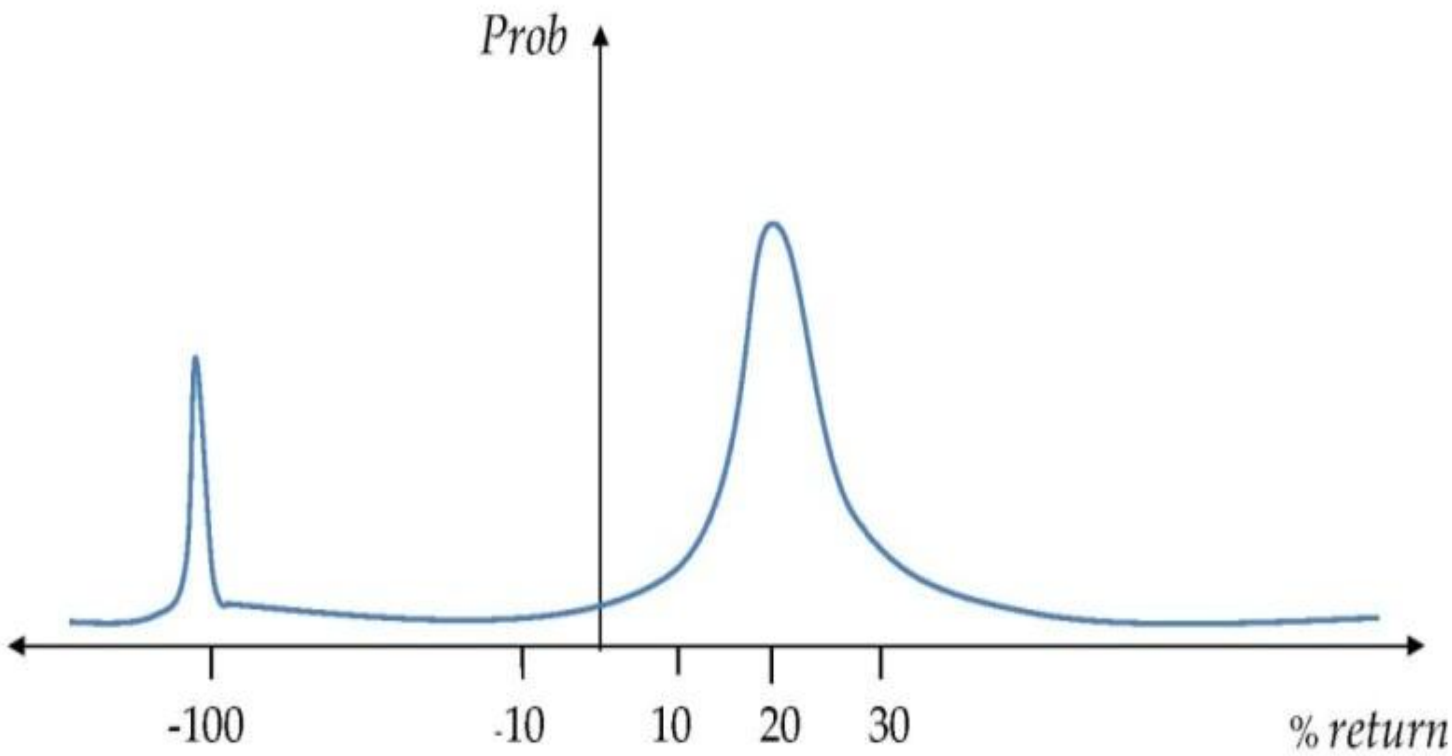
The business models of these three kinds of bank had been very different

High margin, volatile and small scale versus low margin, stable and big

- Search for yield - risky
  - Securitisation, Leverage, slice and Dice
  - Creation of risk by faulty modelling
  - Creation of tail risk – see figure
  - Creation of risk by interconnectedness and lack of knowledge
  - Creation of risk by lack of care in interconnections of system
- Creation of risk by leveraging the productive sector
  - Case of Southern Cross in UK
- Creation of risk by extraction of high fees -
- Creation of risk by Apparent Fraud
  - Goldmans' Abacus Case

…this activity appears not to have regard for needs of clients or for the trust of individuals in the financial system….

Figure 2



3 Failures of Regulation

- Until late 1960s banks were 'recognised by the Bank of England. Cooperative solutions of difficulties. Informal but effective sanctions.
- Bank gradually lost authority from late 1960s
  - Admission of unregulated fringe banks – often foreign
  - Johnson Massey crisis 1984
  - BCCI 1991
  - Maxwell's death, also in 1991
- Move towards FSA
  - *Philosophy "sometimes implicit and sometimes overt" was to that primary reponsibility for managing risks lies with senior management and boards of individual firms", and customer protection best ensured by transparency and rules of conduct, rather than by direct intervention."* Turner Review
  - *But still principles based in system in which players lack principles* Hector Sants
- The FSA's first set of difficulties allied to those of Basel II
  - Inadequate approach to credit risk – concentrated on formalism rather than on identifying unsound institutions
  - Ignored liquidity risk
  - Ignored macroeconomic risk

…the FSA's second set of set difficulties point towards need to a system with integrity…

4 Integrity and the Ethics of Public Policy

First, what are the ethical implication of selfish individualism

- Bentham's utilitarianism, developed by Mill
  - Arose from the project of the *Wealth of Nations*
  - Sought the greatest good for the greatest number
- The early c20 in philosophy
  - Logical positivism – meaningful statements were either factual or logical – a retreat from ethical statements
  - Robbins *The Nature and Significance of Economic Science*
- How is trust established by individuals in this world?
  - Caveat emptor is the norm
  - Trust only established by repeated games, reputation, reputational agencies (aka ratings agencies)
- Not plausible basis for trust – and financial sector is highly trust intensive
  - Trust made more difficult in complex institutions

Implications of the view of human behaviour to be found in Smith's *Theory of Moral Sentiments*

- *"How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others"*
- Learn from an early age to view our own behaviour as it would be seen by an 'impartial spectator'; such a spectator would have regard for the effect of our behaviour on others

- Variants
  - Avner Offer – we desire to be thought well of by others and to earn this approbation we ourselves do well towards others
  - Lyn Stout *Cultivating Conscience:* as a matter of fact people behave in this way
- Smith argues that other regarding behaviour is necessary in some circumstances and not in others.
- The importance of framing
  - Blood giving – comparing the UK and the US
  - After 9/11 many gave blood – but normally giving blood requires financial incentive

….Financial reform may require the framing of some activities as those in which other-regarding behaviour is appropriate….

5 Creating Integrity in the Financial System

- Regulatory System in US is rules based
  - Inflexible
  - Appears to owe its origin to system in which th4re is inadequate trust
- That in UK is principles-based, and allows for the development of integrity
  - Greater flexibility
  - Focus on goals
  - But difficulty outlined above
- Have also been calls for “outcome based” regulation – this seeks to develop Basel II ideas and now clear how clear easy it would be to do this. Dangers that this might kill ethical obligations
- FSA itself does not seek to lead the industry on ethical issues.
- Some other system necessary

- Examples of systems with integrity include
  - Council of Law Society in the UK "*to set, promote and secure in the public interest standards of behaviour and professional performance necessary to ensure that clients receive good service and that the rule of law is upheld*"
  - General Medical Council io the UK: registers (and bans) doctors, enforces codes of medical practice, and implements disciplinary proceedings. Views its role as protector of patients. Code of Medical Good pracatice contains ethical guidance on matters
  - New York diamond exchange – risks of trading of blood diamonds and risk of theft – diamonds are easy to steal. System is a social one enforced through the Jewish community
  - Regulation of the use of child labour by garment industry
- Two models – Self Regulatory Organisations and Professional Associations

- The regulatory system for financial services in the UK that existed before the creation of the FSA relied heavily on self-regulation,
  - and some still exists, for example for the London Stock Exchange.
  - The UK has a long history of encouraging and utilising SROs in many industries,
  - some UK legislation and institutional arrangements still require this.
- Proponents of self-regulation argue that
  - it provides an excellent mechanism whereby the expertise and practical experience of the industry can contribute to the development of regulatory policy,
  - that administrative and compliance costs are lower and that
  - voluntary compliance is more likely if industry players are also stakeholders in the rule-making body.
- Opponents argue that self-regulatory bodies are
  - often subject to conflicts of interest between their regulatory responsibilities and their business objectives,
  - lack transparency
  - encourage anti-competitive practices
- Framework required –
  - Ethical standards required
  - Need management and resources
  - Need both preventative and reactive capabilities

- Examples of successful Professional Associations include
  - Council of Law Society in the UK "*to set, promote and secure in the public interest standards of behaviour and professional performance necessary to ensure that clients receive good service and that the rule of law is upheld"*
  - General Medical Council io the UK: registers (and bans) doctors, enforces codes of medical practice, and implements disciplinary proceedings. Views its role as protector of patients. Code of Medical Good pracatice contains ethical guidance on matters

- Opponents argue that these can also be anti-competitive
- Whether to press forward with Self-Regulation or Professional Association depends a great deal of

Conclusion

- A move away from the selfish behaviour assumption opens up a number of possibilities for the development of integrity in the financial sector