



Ethical Issues in Financial Activities

This paper is the result of work by some fifteen people who hold senior positions in Geneva's financial sector or are external observers of the financial world. The group was established on the initiative of the Observatoire de la Finance. Its objective was to consider ethical issues which are raised by financial activities, taking into account both the specifics of transactions and the general context in which they take place. In doing this the group did not seek to propose another code of conduct or to provide answers, but rather to see whether the issues have genuine validity.

This document is thus a way in, a starting point for any relevant institution or profession to begin its own investigation and clarification of the ethical issues raised by financial activities. It is thus aimed above all at decision-makers in financial institutions – savings and credit banks, investment banks, finance companies and fund managers, intermediaries and advisers, insurance companies and financial managers of large industrial organisations. It will also be of interest to public bodies and legal agencies involved in supervising and regulating the financial sector.

The individual members of the group, and the Observatoire de la Finance on their behalf, would like not only to share their experience, but also, above all, to facilitate this investigative exercise in specific institutional or professional contexts. The scope of this initiative extends beyond Geneva and indeed Switzerland; its ultimate aim is to encourage the establishment of groups which have a similar vision.

The Observatoire de la Finance – a foundation under Swiss law, based in Geneva – provided secretarial assistance for the group and supervised its work. The group was an informal one; those who participated did so as individuals without necessarily expressing the views of the institutions for which they work.

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1. The role and responsibilities of financial operators

The financial sector likes to call itself a “service industry”. As such, its role is to guarantee the fluidity of transactions which are essential to economic activity by ensuring the best possible use of available capital. The recent explosion in financial activity, which has grown much faster than the rest of the economy, has, however, permitted this service industry to gain a certain degree of independence from, or even control over, the so-called “real” economy. This process has been accompanied by the growing isolation of finance, both conceptually and as a profession.

That this new state of affairs creates opportunities is beyond doubt, but it also has potentially serious consequences. Recent events (LTCM, the Asian and Russian economic crises, etc.) have unambiguously shown how crucial the responsibility of individual and institutional players in financial markets is. The use of leverage has enabled banks and other financial players to commit and withdraw sums of money far greater than they have received from their clients. As a result, the financial markets are capable of transforming a recession into an economic depression, or at least triggering one off, with all the risks that this entails both at individual and collective level.

The sums that can be mobilised on the markets, which bear little relation to the underlying transactions in the real economy, are the principal source of responsibility of financial markets both in normal times and during crises. The amounts involved are colossal, and financial players should endeavour to behave in such a way as to ensure confidence among other players and keep the economy running smoothly in normal times and avoid causing panic in times of crisis. However, this responsibility also includes a more long-term element, that of correcting dysfunctional aspects of the markets. This means that players should also encourage the pursuit of financial and economic innovations which will improve the system and ensure that financial decisions take fuller account of the common good. Even if the financial sector cannot be held responsible for all that is good or ill in the economy, it bears a heavy responsibility for the allocation of resources at both macro and micro level.

For their own sake, all the players on financial markets must make an effort. The issues concern not only individuals, but also institutions. These two levels of responsibility are complementary. Whether the problem is tackled in terms of the interests of individual or institutional holders of capital or in terms of the ethical aspects of financial professions and practices - or indeed the common good - the new situation demands a clear definition of the responsibilities of the various financial players.

➡ If finance is a service activity, it is important to specify what services it renders, to whom, in return for what, and for what purpose. In the absence of such clarification, finance may slide out of control and be left at the mercy of mass enthusiasm or hysteria. As the stock-market panics and crashes of the past have shown only too clearly, the potential implications of such a development are appalling.

The aim of this document is to take the first steps in this process of clarification. Its purpose is not to come up with ready-made answers in the form of a charter or code of conduct, but rather to identify the issues of responsibility that face individual and institutional financial players.

2. Unrecognised responsibility

The recent expansion of the financial sector has been characterised both by an unprecedented degree of specialisation in the financial professions and by a growing diversity of activity

carried on within a single institution. This has resulted in increasingly specialised activities at the individual level, within increasingly complex organisations. In response to these changes, financiers are struggling – seemingly more than in the past – to express their responsibilities in ethical terms, as the impact of their decisions continues to grow.

The following four factors have tended to obscure financial players' view of the consequences of their actions:

- They are operating **in a world that is isolated by technology** from the realities of the real economy. The use of highly developed technology tends to create a seemingly virtual world in which the very real consequences of financial operations remain invisible. It is all too easy for financiers to remain cut off in this world of symbols and virtual reality;
- The financial world is **institutionally and culturally distant** from other economic sectors, and this makes it difficult to take into account the effects of financial operations on other economic players;
- Financiers use **highly sophisticated models and paradigms which nevertheless, like all models, fail to express the full** complexity of the world in which they are operating. In this sense, such models are inevitably simplistic, and the absolute value that is attached to them by financial players has serious implications;
- Financial markets present themselves as almost perfect markets, in the sense of a **theoretical ideal on which individual players can have little influence**. From time to time certain individuals use this to abdicate their own responsibility with the excuse "It's not me, it's the market!". This is grossly misleading, for it is clear to all that they are taking advantage of market imperfections and that the market's supposedly ideal behaviour is only a theoretical construct whose limits are readily apparent.

The distance created by these four factors tends to make financial players lose sight of their responsibility; instead, they are inclined to think of their world as a system that operates according to immutable rules. In such a context, the freedom of individual players is artificially restricted to the use of models. Outside this system, whose dominance appears inescapable, the individual player feels totally incompetent and, as a result, powerless. Such utter reliance on the system thus helps to blur individual responsibility.

- We are therefore faced with a paradox: a huge responsibility in view of the sums involved, and a diminishing awareness of this responsibility due to financial players' technological and institutional isolation. This isolation is further increased by a tendency to seek refuge in intellectually simplistic models and systems.

How can one break through the veil and encourage financiers to shoulder more of their objective responsibility, which fatalism, or blind faith in the system, too often tends to obscure? This is an area in which risky experiments are neither desirable nor feasible, and any suggested solution must take account of this. "Ready-made" recipes will not work. Instead, one must distinguish between the different kinds of responsibility which apply to different kinds of companies, professions or functions within the financial world:

- "Institutional" players, i.e. pension and investment funds and insurance companies which manage their clients' assets;

- Bankers who take deposits from the public and make use of them, mainly in order to grant loans;
- Brokers and other market intermediaries acting on their own behalf or that of third parties;
- Corporate treasurers who manage company finances, and whose main job is to provide a link between the industrial and financial spheres;
- The public sector, as an issuer of bonds which enable various activities to be carried out by public bodies.

Each of these functions involves an equal degree of responsibility, but the individual characteristics of each sector mean that this responsibility must be interpreted differently in each case. This issue is especially important for large companies which are performing several different functions at once and are thus bringing together a broad array of different professions within their walls. In these circumstances, it is increasingly difficult to shift from the responsibility of each of the various professions to that of the institution itself.

Despite this additional difficulty, the basic question remains the same; how can financial players be encouraged to behave responsibly?

3. Issues of responsibility

Responsibility in the area of finance is not simply a matter of private ethics. It also involves establishing and maintaining bonds of trust between holders and users of capital, as well as between the operators themselves. Such trust is the corner-stone of efforts to achieve the common good, whereby the interests of individual operators and financial institutions are integrated with those of the community at large.

The need for truthfulness: This is particularly important in the present context, in which financial institutions are less and less easy to define in terms of a single function, rather as global conglomerates now boast that they offer “global service”. Clients should know, and should want to know – as clearly as possible – what kind of financial operator they are dealing with. Clients dealing with a traditional bank will have quite different expectations than when dealing with a broker. To eliminate all ambiguity, financial operators have a duty to present themselves in their true colours.

In periods of rapid change, maintaining a truthful image becomes a permanent duty for financial operators. In cases where an institution changes its strategy or field of activity, there is an increased risk that the image inherited from the past will no longer be accurate. If operators then fail to adjust their image to the new situation, clients may be misled. One of the preconditions for creating client relationships based on trust is therefore that the institution’s image must correspond to its range of activities.

Durability: Unlike other economic transactions, which are more or less instantaneous in nature, investment is a long-term undertaking.

Contemporary finance is based on an essential paradox: long-term security depends on the possibility of a quick exit, which presupposes liquidity. The stability of the financial system depends on maintaining equilibrium between these two aspects: security and durability. Unfortunately, the expansion of markets and the proliferation of vehicles for investment tends to obscure the durability dimension while creating an illusion of security. The growing speed

and the irrational nature of financial transactions is making it increasingly difficult to reconcile these two goals.

The growing divide between the return on financial investments and capital invested in the real economy can be explained in the same way. The obsession with liquidity and the frenzied hunt for short-term gain which, some would claim, creates wealth has a material and psychological impact on the real economy and on holders of capital. This impact is not taken sufficiently into account when financial decisions are made. It is therefore important to find means other than the frenzied pursuit of liquidity to recreate bonds of trust between players, on whose cooperation the smooth running of the economy and the stability of the financial system depend.

The problem of durability requires a clear definition of the various players' responsibilities. At present, financial contracts are too vague in this regard. Who is the seller or creditor and who the buyer or debtor, what is being bought or sold, and what are each player's responsibilities in the event that contractual obligations are not fulfilled?

Ethical remuneration: The way in which remuneration is determined must avoid encouraging the financial operator to deceive the client by giving unfair advantage to one form of transaction rather than another. It should also avoid encouraging the operator to seek profits greater than set out in, or reasonably foreseeable under the terms of, the contract. This, of course, is not to suggest that contracts should mislead the client by suggesting that there is no remuneration at all, but rather that information concerning commissions, etc. should be easily accessible to the client.

Respecting the client's interests must be a priority when determining the conditions of remuneration, even at the risk of reducing the institution's profits. The fact that this priority is so difficult to observe within increasingly complex financial institutions makes it all the more fundamental, for there will always be a temptation for the various subdivisions of the institutions to use the client base, or the information held and obtained by other subdivisions, for their own purposes.

Transparency and asymmetrical information: Much has been said about the importance of giving clients transparent information, but transparency by itself is an illusory virtue. The reality is that asymmetrical information is the corollary of financial specialisation and expertise in financial markets, and that transparency between two people who are not equally capable of understanding the information will not by itself lead to more responsible behaviour. The issue of trust is much more important here, and allows a more useful definition: it is not simply a matter of providing unprocessed information, but of ensuring – through proper instruction – that any abuse of power arising from the inevitable asymmetry in people's ability to understand the information is avoided. In this connection, trust between the client and the financial institution may sometimes need to be re-established by having recourse to third parties such as trust companies or supervisory bodies.

Respect for the rules of the market: The market is a delicate mechanism whose operation may prove dangerous when pursuit of personal gain harms the public interest or efforts to achieve the common good. Examples include manipulation of share prices, use of market prices for unofficial transactions so that the market is not affected, and inappropriate use of information gleaned from the market, especially in order to determine the financial operator's remuneration.

4. Instruments of trust

Relationships based on trust, on which financial transactions and market stability depend, necessitate abiding by a number of principles which will enable the various players involved to understand one another's objectives and expectations. The establishment of appropriate procedures is often rightly quoted as an example of this, but this should not lead one to forget the more substantial aspects of financial operators' contribution to the common good.

Personal relationships: Trust can often be established on the basis of personal links between clients and financial operators. This depends on operators being genuinely and spontaneously committed to such principles in a spirit of integrity and loyalty, and on the institutions concerned abiding by those principles.

Charters and codes of ethics: Drawing up codes of ethics may have a doubly positive effect if it is done with a genuine concern for the principles mentioned above. Externally, such codes tend to increase clients' and partners' trust, since they involve an explicit undertaking to abide by certain rules of conduct. For this reason, they should be given appropriate publicity. Internally, codes should result in a debate among employees about the ethics of what they are doing. They lead to clarification of the institution's objectives and encourage individual operators to establish and maintain bonds of trust in the course of their professional activities. For these reasons, the regrettably frequent habit of adopting the best-known type of code or charter without there being any serious internal debate represents a missed opportunity.

Regulation of financial markets: This highly topical issue places finance at the heart of the public debate, which is justified in view of its current importance. The regulation of financial markets may, in fact, have a doubly beneficial effect. Firstly it clearly sets the limits of legal financial activity, and secondly it points the way towards fuller acknowledgement of ethical imperatives. Governments' responsibility for both regulation and education should therefore not be underestimated. It is also essential to draw up appropriate policies at multilateral level in order to guarantee observance of the basic rules of conduct. In this connection, the practice (currently proposed by multilateral institutions) of privatising profits and mutualising losses is unsatisfactory.

However comprehensive procedures may be, they will never succeed by themselves in providing a satisfactory answer to the problem of responsibility of economic players (financial or otherwise). In addition to sound procedures, this depends on proper behaviour and attitudes within institutions. It also requires harmony between the institution's culture, its methods of internal communication and the way in which it views itself in the world of finance and the world at large.



This document has identified the issues, put them in perspective and suggested some avenues for possible solutions. However, even if the first step has now been taken, there is still a long way to go. Other steps in the process will include more in-depth analysis, confrontation with other sectors of the financial world, and drafting of reference documents for use by other interested parties - to mention just a few examples.