Where Ethics Matters in Finance

Ethics & Trust in Finance Global Prize Awards 2018–2023

Edited by
Paul H. Dembinski
Josina Kamerling
Virgile Perret

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C/o Observatoire de la Finance
16, chemin des Clochettes
1206 Geneva, Switzerland
Website : www.ethicsinfinance.org
Email: info@ethicsinfinance.org

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As IOSCO Board Chair, I commend all participants for taking an interest on the issue of ethics and trust in finance, and for promoting awareness on the issue.

Ethics in finance is not a mere regulatory requirement; it is the foundation upon which trust is built. It is therefore a shared responsibility between all market participants, intermediaries, and regulators to safeguard the integrity of our global financial system. The global nature of interconnected financial markets reinforces the importance of setting baseline definitions for ethical conduct at a global level.

These ethical considerations are particularly relevant as we navigate an era of rapid and transformational changes in the likes of climate change and digitisation of financial services. IOSCO has a long history and successful record of accomplishments in developing principles and standards that enhance the integrity of financial markets and fair conduct of market intermediaries. The nominees and winners of this year's prize have focused on a highly relevant set of salient challenges faced by the financial sector, such as sustainable finance, digitisation, finfluencers, and discrimination. I congratulate them for the quality of their contributions.

Jean-Paul Servais, Chair of the International Organization of Securities Commissions (IOSCO) & Chair of Belgium's Financial Services and Market Authority (FSMA) - Bruxelles, December 2023

This "Ethics and Trust in Finance" prize has a really compelling narrative – that more ethical finance can help rebuild trust in the sector. Trust in the financial sector took a big hit during the global financial crisis, and that distrust continues to linger. It is essential that people trust banks and the financial services sector more widely. This is as important for the financial system itself as it is for individuals, as trust is the basis of all good and stable relationships.

The nominees and winners of this year's prize have presented original and worthwhile ways to restore trust, in areas including access to finance, fair lending, sustainable investing and approaches to new technology. I congratulate them and look forward to seeing their ideas applied.

Mairead McGuinness, European Commissioner for Financial services, Financial stability and Capital Markets Union - Bruxelles, November 2021

Public trust in the financial sector is crucial for market economies. Yet, ten years after the crisis, and in spite of significant reforms, trust in financial institutions in OECD countries remains low. According to the *2019 Edelman Trust Barometer: Financial Services Report*, although the levels of trust in the sector among the general population have improved slightly, financial services remains the least-trusted sector measured by the barometer, with levels of trust of 57%. This needs to change.

Financial systems are made of trust. Their strength stems from public confidence. This is why ethics in financial institutions are vital. This is why we need to reflect and debate about ways to make this sector more reliable, more accountable, more transparent, more inclusive. And this is why efforts like the *"Ethics & Trust in Finance"* Global Prize published by Observatoire de la Finance are so important.

I very much hope that this collection of essays will stimulate our imagination and enrich the debate on how to strengthen the ethical behaviour and the integrity of the financial sector. I want to congratulate all the finalists of the Ethics & Trust in Finance Prize for their ground-breaking works, their new ideas and their faith in more responsible and trusted financial sectors.

Angel Gurría, Secretary-General of the Organisation for Economic Co-operation and Development (OECD) - Paris, October 2019

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Ethics & Trust in Finance

The Global Prize Ethics and Trust in Finance promotes new ways of thinking about the big challenges facing the global economy and finance. As a worldwide program running since 2006, we work with inspiring minds from across the financial and academic ecosystems to conceive of new models and shape better practices that strengthen the foundations upon which we build our world.

In today's global system, where millions unable to access the financial services need to flourish, a more transparent, more accessible and inclusive model is required and is possible. Meanwhile, growing imperatives are driving new approaches to design more sustainable systems of provision of financial services able to limit our impact on the planet.

The competition invites young professionals and academics under 35 to submit unpublished contributions on issues related to ethics and trust in finance. The brightest minds will be recognized by an international jury of prominent experts in finance and ethics, who will award them the sum of USD 15'000 to be shared among the winners.

We believe that ethics and trust have a pivotal role to play in finance as drivers of positive change in an uncertain world. Each edition we look forward to exploring bright new ideas from a brilliant young people, professionals as well as academics.

The Prize today is a well-recognized and highly respected endeavour. To date, in its global edition, the Prize has awarded 42 distinctions to outstanding authors coming from all continents.

www.ethicsinfinance.org

Introduction

Paul H. Dembinski, Josina Kamerling and Virgile Perret

The present volume – already third in the series - contains twenty-nine papers which have been short-listed in three successive editions, spanning from 2018 to 2023, of the global contest "Ethics and Trust in Finance for a Sustainable Future", among them eleven winning contributions. As co-presidents of the Jury, we are happy and proud to be able to introduce this volume to a wider public, in a moment where the need for more ethics and more care for the Common Good are especially present.

About this book

The authors of the essays reassembled here have devoted time and energy to structure their thinking about aspects of broadly understood financial activities that pose ethical questions and generate dilemmas. By doing so they have contributed to advance ethical analysis by clarifying the relationship between very specific issues or contexts and fundamental values.

The volume is made up of five parts, each of them addressing ethical challenges from a different context or angle. The volume opens with five essays addressing ethics in context of access to capital and of financial inclusion. Some of the papers address the problem on a macro level while others look at micro-realities. At every level, the paradox is the same: while capital is abundant, those who need capital the most, access it with greatest difficulties because of real and imaginary risks perceived by the owners of capital. Authors agree that while imaginary risks should be addressed by adequate information, real risks need ad hoc solutions, namely lower – or even nil – expected returns, i.e. less hungry and more patient providers of capital. This is a requirement of social justice.

The papers in the second part discuss ethical dilemmas and challenges posed by extended use of technology in financial activities. Some authors advocate stronger training – sensitivity – of fintech specialists in ethics so as counterbalance their more mostly technical skills while others make a strong point by challenging the widespread – and confutable – view of "neutrality of technology". The case of "virtual currencies" and the corresponding ethical concerns are also addressed.

The third part of the volume focuses on the nexus of finance and sustainability, understood in its variety of shades of green. The problems discussed in the six essays are part of a worldwide debate about the potentials and the shortcomings of the array of diverse instruments and techniques that aim at making ecological, social and governance impacts part of investment decisions. The relation between ethics and sustainability is analysed, and their complementarity is stressed, as opposed to often mentioned redundance.

Part four is made of papers that focus on ethical issues in banking and regulation. The cross-cutting question is how to make banks more responsible. The authors propose different remedies: better regulation and closer oversight, a compulsory "capital buffer" as guarantee, ethical screening of rules of bank resolution, ethical rating agency, shortcomings and limitations of banking secrecy. The part ends with a forceful discussion of the ethical pros and cons of offshoring strategies.

The essays of the final part of the book have in common to look at the ethical aspects in cultures (corporate and professional) and in typical behaviours in various compartments of the financial industry. The shared concern of the authors is how to encourage the ethical component and deter what is seen as less ethical. Specific tools aimed at raising the ethical awareness of the professions are discussed in the first place, then the attention goes to a critical view and limited efficiency of ethical codes, finally tools for making contracts and product more ethical are also proposed . The volume closes by focusing on ethical concerns – and possible need for ad hoc regulations -raised by an emerging category of financial actors: financial influencers.

The authors

The variety of entry points through which the authors take on the ethics-finance nexus is rewarding. It shows that the upcoming generation of professionals and academics in finance is alert to the multiple forms of ethical challenges that the industry is facing. Even if not all papers published here did reach the podium, they have all contributed to this volume which should be seen also as a testimony of concerns. The contribution to this testimony stem from sixteen countries, 9 European, 4 African and 3 American. Despite the absence of Asia, this volume deserves to be seen as a global testimony. While almost two thirds of the authors are young professionals active in private, public or social institutions, the remaining groups is made of academics, students as well as teachers. In terms of gender, one third of the authors are women.

The variety of professional backgrounds among the shortlisted submissions to the competition, shows clearly that our Prize is not just another academic competition. It focuses on sharp, short, well documented and structured arguments carrying innovative conclusions and propositions for action.

Award Ceremony

The young authors are the heroes of the Prize. They are celebrated, at the end of each edition, at the Award Ceremony. In 2019, the closing Ceremony of the 7th edition took place at the headquarters of OECD thanks to the hospitality of the secretary general Angel Gurria who delivered a keynote address. Unfortunately, due to the pandemics, the two last Ceremonies took place online with prestigious keynote speakers: in 2021, Mairead McGuinness, European Commissioner for Financial Services, Financial Stability and Capital Markets Union (8th edition) and in 2023, Jean-Paul Servais, Chair of the International Organization of Securities Commissions (IOSCO) and Chair of Belgium's Financial Services and Markets Authority (FSMA) (9th edition).

The Ceremony is the most visible part of the iceberg of the Competition. The less visible parts of the contest organisation are the Jury, the Strategic Partners and the Secretariat. The list of the Jury members who were involved in one or more of the editions – global or linguistic - between 2017 and 2023 are listed on pages 431-442. Each of the members deserves our heartfelt thanks for their pro bono contribution to this common endeavour..

Acknowledgments

CFA Institute, Euroclear, Pictet Group, Swift, Swift Institute, Association of Certified Chartered Accountants (ACCA), OECD and the Board of the Foundation of the Observatoire de la Finance based in Geneva deserve special recognition and thanks. Without their unwavering support the Prize would not have reached its present prestige and visibility.

Last but by far not the least is the secretariat of the Prize performing the daily work from the launch to the final closing and publication of each of the editions. Mrs Hannah Soissons and Mr Virgile Perret deserve our unlimited gratitude for the common and successful leadership of the Prize.

Part I

Access to Capital for Inclusion and Development

Rethinking gender scoring to gain fairer creditworthiness assessments

Ethics & Trust in Finance
Global edition 2022-2023

First Prize

Josiah Wamwere-Njoroge
Kenya
Postgraduate Student,
Kenya School of Law,*
Nairobi (Kenya)

* The views expressed herein are those of the authors and do not necessarily reflect those of the Organization he is affiliated with or of the Jury.

Introduction

In this era of digital transformation, societies find themselves at the intersection of ethics, finance, and technology (Davis, Kumiega & Vliet, 2013). As we embrace the digital revolution, one theme that demands immediate attention is the ethical implications surrounding the algorithmic scoring of consumers in creditworthiness assessment procedures. In the realm of finance, where numbers and calculations reign supreme, we often assume that decisions are made objectively, devoid of any biases or discriminatory practices. However, the emergence of algorithmic decision-making in creditworthiness assessment procedures has challenged this assumption, revealing a world where gender-based algorithmic scoring can have profound implications for consumers.

Automated decision-making has the potential to bestow countless benefits on society, empowering financial institutions to make informed decisions based on vast amounts of data. Yet it also carries the inherent risk of undermining people's rights and freedoms. Discrimination, disguised within the algorithms, can silently permeate creditworthiness assessments, leading to unjustified denials of services and goods.

In developed economies, regulatory frameworks have been established to safeguard against the utilization of certain data types in credit risk analysis. For instance, in the US, regulations prohibit the inclusion of race data and zip code data, while the UK protects

category data (OECD, 2021, p. 45). Additionally, the US Equal Credit Opportunity Act (ECOA) of 1974, along with its amendments in 1976, have played a significant role in shaping credit practices by addressing issues of discrimination in credit access. (Bumacov, Ashta & Singh, 2017, p. 549). By explicitly prohibiting discrimination based on factors such as race, religion, gender, marital status, and age, the ECOA aimed to foster fair and unbiased lending practices. In the EU, the use of gender in decision-making processes is also explicitly prohibited by law. This prohibition stems from the broader framework of antidiscrimination provisions that aim to ensure equal treatment in various aspects, including goods and services (Andreeva & Matuszyk, 2019, p. 1288). One of the key legislative measures in this regard is the European Equal Treatment in Goods and Services Directive (2004/113/EC), which was enacted by the European Council in 2004.

The prohibition of gender scoring, which refers to the exclusion of borrower gender data in credit-scoring models, plays a crucial role in the fight against discrimination. It sends a powerful message that gender should never be a determining factor in creditworthiness assessments. If algorithmic systems are allowed to utilize gender as a determining factor, they risk reinforcing regressive stereotypes and exacerbating gender disparities in economic opportunities. This would not only undermine social progress but also inhibit economic growth by excluding talented individuals from accessing the resources they need to thrive. By eliminating gender as a scoring factor, we lay the foundation for a more inclusive and thriving society, where talent and potential can flourish without unjust impediments.

Yet it is crucial to acknowledge that banning gender scoring may not be a foolproof solution to ensure non-discrimination by algorithms (Anderson, 2022, p. 39). A counterintuitive consequence of the prohibition of gender scoring is the potential negative impact on gender equality. Research has suggested that eliminating gender scoring could inadvertently result in a decrease in credit access for creditworthy women (Bostic & Calem, 2003). This unintended consequence is contrary to the very principles we seek to uphold—equality and empowerment. As a result, a critical question emerges: How can we strike a balance between eradicating discrimination and ensuring equal opportunities for all?

At the heart of this essay lies a fundamental inquiry: Is there a more effective approach to tackling discrimination in algorithmic credit lending decisions than solely relying on the prohibition of gender scoring? There is a pressing need to find a better approach, one that transcends the mere prohibition of gender scoring and addresses the

nuances of non-discrimination in algorithmic decision-making for credit lending. The essay proposes a discrimination definition that centers on balancing error probabilities within the algorithmic system. In simpler terms, the goal is to ensure that the algorithm's errors, both false positives and false negatives, are distributed equally between genders.

This perspective challenges the conventional belief that the prohibition of gender scoring alone is sufficient to eliminate discrimination. The proposed approach emphasizes the evaluation of error distribution as a means to comprehensively assess the fairness of algorithmic decisions. Central to this approach is the pursuit of parity in the probabilities of positive credit decisions for creditworthy individuals, irrespective of their gender. A more equitable system can begin to take shape when the algorithm demonstrates an equal likelihood of approving creditworthy men and women. Furthermore, it is imperative to ensure equal probabilities for non-creditworthy individuals, both women and men, in receiving negative credit decisions.

The implications of this analysis extend beyond theoretical discussions. They have real-world consequences for individuals seeking fair access to credit and financial opportunities. By redefining how we evaluate discrimination in algorithmic decision-making, we can pave the way for more inclusive and equitable credit lending practices.

The subsequent sections of this essay unfold as follows: Section 1 undertakes an examination of the immense influence and application of algorithms in creditworthiness assessments. Building upon this foundation, Section 2 delves into the complex challenges posed by the exclusion of gender as a scoring factor in algorithmic credit scoring, accompanied by a proposal that advocates for a comprehensive framework aimed at ensuring equitable and impartial outcomes in creditworthiness assessment algorithms. Subsequently, Section 3 discusses the multifaceted role of gender within algorithmic credit scoring, unraveling its intricacies and uncovering its significance in the broader context of credit evaluation. Finally, the concluding section provides a concise summary and synthesis of the key findings and implications derived from this analysis.

Algorithmic Decision-Making in Creditworthiness Assessment Procedures

The term "algorithmic decision-making" itself evokes a sense of mystery and intrigue, conjuring visions of complex codes and digital marvels. But what does it truly mean in the context of creditworthiness assessment procedures?

Cormen et al. (2022) define an algorithm as "a sequence of computational steps that transform the input into the output" (Cormen

et al., 2022, p. 5). They therefore serve as guiding principles that enable computers to make decisions and execute tasks. However, algorithmic decision-making extends beyond the realm of rule-based automation alone (Kerrigan, 2022, p. 35). The applications of technology are expanding towards more autonomous systems, blurring the boundaries between rule-based and AI-based solutions (Fishman & Stryker, 2020, p. 15). Thus, the term "algorithmic decision-making" serves as a useful umbrella term that encompasses both rule-based and AI-based approaches.

While this essay primarily focuses on rule-based automation in the context of gender-based algorithmic scoring, the principles presented may also be applicable to AI-based algorithms. The fundamental goal of ensuring non-discrimination and fairness in algorithmic decision-making transcends the specific technological implementation. Whether the decision-making process is rule-based or AI-based, the ethical and trust-related challenges remain pertinent.

The Power of Algorithms

At the heart of algorithmic decision-making lies the pursuit of efficiency and data-driven insights (Werbach & Cornell, 2021, p. 37). These systems can incorporate an unprecedented amount of empirical data, surpassing the limits of human cognition and processing power (Portuese, 2022, p. 5). By automating the credit application process, these algorithms navigate the labyrinthine landscape of financial assessments, evaluating factors such as income, payment history, and outstanding debts with remarkable speed and precision (Nalic & Martinovic, 2020).

In this domain, the role of human decision-makers diminishes, making way for the silent wisdom of algorithms. But what does this mean for the consumers who seek financial support? How do these algorithmic systems assess their creditworthiness?

The Complexities of Creditworthiness Assessment: Navigating Human Behavior, Financial Factors, and Demographic Characteristics

Within the framework of a loan agreement, the temporal dimension emerges as a distinguishing factor. Unlike other types of transactions, lending entails a temporal discrepancy between the disbursement of funds and their subsequent repayment (Turnbull, 1998, p. 343). This inherent characteristic of loans necessitates a meticulous assessment of the borrower's dependability, ensuring that lending institutions can have confidence in the borrower's ability to fulfil the repayment obligations according to the predetermined terms (Genberg, 2020, p. 71) The evaluation of creditworthiness assumes paramount significance in this context, as it determines whether an applicant,

who seeks credit, possesses the necessary creditworthiness to justify the requested loan amount (Anderson, 2022, p. 2). Essentially, this evaluation endeavours to address a fundamental question: Can the borrower be reasonably anticipated to uphold their financial commitments and fulfill the loan repayment obligations in a timely manner?

However, the assessment of creditworthiness is not a straightforward task. It requires navigating the complexities of human behavior, financial circumstances, and the ever-changing dynamics of life. Predicting the future with absolute certainty is impossible, leading lenders to rely on tools such as inductive reasoning, profiling and credit scoring to make informed decisions (Hallinan & Borgesius, 2020, p. 9). These tools, when used responsibly, can provide valuable insights into a person's creditworthiness, providing lenders with a consistent and standardized approach to assess creditworthiness.

As highlighted by Kamp, Körffer & Meints (2008), the parameters employed in credit scoring can be categorized into three main groups: contract-related parameters, financial criteria, and demographic characteristics (Kamp, Körffer & Meints, 2008, p. 207). Each of these categories provides insights into an applicant's creditworthiness.

Contract-related parameters encompass factors such as the number of credit cards and loans, as well as the duration of previous contractual relationships between the borrower and lenders (Vercammen, 1995). These parameters offer insights into the borrower's financial history and behavior, serving as indicators of their ability to meet their financial obligations. Financial criteria, on the other hand, delve into an applicant's assets, income, and expenses, providing an understanding of their financial capacity to repay a loan (Cowan & De Gregorio, 2003, p. 165). These parameters form the backbone of creditworthiness evaluation, enabling lenders to assess an individual's financial stability.

However, it is the third category of parameters, namely demographic characteristics, that has garnered significant attention, particularly concerning gender-based algorithmic scoring. Alongside gender, variables such as address, age, number of children, residential area, education, occupation, employer name, nationality, and religion have historically been used in credit scoring models (Anderson, 2022, p. 84).

Lenders do not possess unfettered discretion when it comes to determining the information they utilize in their creditworthiness assessments. The fundamental principles of the rule of law demand that decisions be rooted in accurate and relevant information, tailored to each unique situation. Thus, the question arises: how do we discern which factors hold relevance in specific circumstances?

One approach is to consider variables that have demonstrated their ability to predict loan repayment with a reasonable level of certainty (Abdullah et al., 2020, p. 81.). These variables, backed by empirical evidence, can provide valuable insights into an applicant's creditworthiness. By relying on well-established indicators, lenders can minimize the risk of making erroneous judgments and ensure that their assessments are grounded in a reliable foundation.

This is where algorithmic scoring systems come into play. By harnessing the power of data and automation, algorithms aim to streamline the creditworthiness assessment process, bringing efficiency, consistency, and objectivity to the table (Genberg, 2020, p. 71). In recent years, algorithmic decision-making has gained traction as a tool to streamline and automate creditworthiness evaluations. Algorithms, driven by vast amounts of data and intricate calculations, analyze numerous attributes to generate a credit score for each applicant. These attributes can include income, employment history, debt-to-income ratio, and even personal characteristics such as gender. It is here that the potential for bias and discrimination comes to light.

Beyond Gender Exclusion: A More Comprehensive Approach to Address Bias in Algorithmic Credit Scoring

Various approaches have been proposed to mitigate algorithmic discrimination. One such approach, as suggested by Lepri et al. (2018) involves avoiding the use of sensitive attributes, like gender, in the decision-making process. The rationale behind this approach is to eliminate direct gender-based scoring, thus reducing the potential for discriminatory outcomes (Lepri et al., 2018, pp. 615-618).

Unravelling Algorithmic Discrimination: The Challenges of Excluding Gender as a Scoring Factor

At first glance, it may seem like a straightforward solution. By refraining from considering gender as a scoring factor, the algorithm's decisions would be free from explicit gender biases. However, the complexities of the issue become apparent when we realize that the impact of gender can still permeate the algorithm through its correlation with other variables used in the scoring process (Anderson, 2022, p. 39).

To illustrate this, consider a hypothetical scenario where gender is excluded as a direct scoring factor. However, if other variables that are correlated with gender, such as occupation or educational background, are still taken into account, the algorithm may indirectly incorporate gender biases. This is because certain occupations or educational paths may have historically favored or disadvantaged individuals of a particular gender.

As a result, the algorithm might inadvertently perpetuate gender-based inequalities, even without explicitly considering gender as a scoring attribute. For example, if historically more women have worked in lower-paying occupations or have had limited access to higher education, these factors might indirectly affect their credit scores. In such cases, the exclusion of gender as a direct factor does not fully eliminate the influence of gender on the algorithm's decisions.

Additionally, removing gender-based scoring from creditworthiness assessments brings forth another complex dilemma as lenders may struggle to maintain the desired level of overall risk assessment. However, research suggests that this decline in accuracy is unlikely to be significant in the lending context (Andreeva & Matuszyk, 2019, p. 1287). Lenders have access to a wealth of other variables that can effectively gauge an applicant's creditworthiness and maintain the desired risk levels. However, while the overall accuracy of credit decisions may remain intact, the concern lies in the potential uneven distribution of errors between genders. Without gender-based scoring, there is a risk that the algorithm may disproportionately make incorrect decisions for one gender over the other. This raises questions about fairness and equality in the creditworthiness assessment procedure.

For instance, studies have indicated that if gender-based scoring is removed, the algorithm may struggle to effectively identify creditworthy women compared to when gender is considered (Andreeva & Matuszyk, 2019). This disparity could result in qualified and deserving women being unjustly denied credit opportunities, undermining their financial prospects and perpetuating gender-based inequalities. Conversely, there is also the issue of the algorithm potentially failing to identify non-creditworthy men as frequently as it does non-creditworthy women. This imbalance in identifying risk may lead to an increased likelihood of lending to individuals who are not capable of repayment, thus exposing lenders to higher default rates and financial losses.

Striking a Balance: Fairness and Accuracy in Creditworthiness Assessment Algorithms

To tackle this challenge effectively, we need to explore more comprehensive approaches that go beyond the exclusion of sensitive attributes. It requires a deeper understanding of how correlations between variables can introduce biases and discriminatory outcomes. By identifying and addressing these underlying correlations, we can work towards creating fair and unbiased algorithms that truly uphold the principles of ethics and trust in finance.

While examining the input

variables used in algorithms is one approach, it may not be sufficient on its own. A promising approach, as suggested by Lepri et al. (2018), involves focusing on the concept of statistical parity (Lepri et al., 2018, p. 616). The idea behind statistical parity is to ensure that the probability of every possible decision outcome is equal across all groups, regardless of sensitive attributes like gender. However, as Lepri et al. (2018) acknowledge, implementing statistical parity in certain contexts, such as lending, may pose challenges. If different groups, such as women and men, exhibit variations in their historical loan repayment behavior, enforcing statistical parity could potentially compromise the accuracy of algorithmic decisions (Lepri et al., 2018, p. 616). Striking a balance between fairness and accuracy becomes a delicate task.

Kleinberg, Mullainathan, and Raghavan (2016) shed more light on the complexities surrounding the establishment of equitable risk scores. These researchers encapsulate the viewpoints presented in existing literature by delineating three fundamental conditions that are crucial in ensuring fairness within algorithmic systems.

The first condition pertains to the calibration of the algorithm, encompassing the idea that if the algorithm assigns a particular characteristic (such as creditworthiness for a specific loan amount) to a certain group (for instance, women) with a probability denoted as x, then x proportion of individuals within that group should indeed possess that characteristic (Kleinberg, Mullainathan, and Raghavan, 2016, p. 2). Essentially, the algorithm's claims must align with the actual distribution of traits within the group. This condition emphasizes the need for transparency and accuracy, where the scores themselves convey their intended meaning without discrepancy when examined within each group.

The second requirement revolves around achieving equal average scoring across all groups for individuals with a specific characteristic, such as creditworthiness (Kleinberg, Mullainathan, and Raghavan, 2016, p. 2). Referred to as *the balance for the positive class* condition, it would require, for example, that the average score for creditworthy women should be equivalent to the average score for creditworthy men. This condition seeks parity in the treatment of individuals with similar traits, regardless of their gender. Consequently, it aims to eliminate any bias or disparity that may arise from the algorithmic decision-making process.

Correspondingly, the third condition, known as *the balance for the negative class* requirement, focuses on maintaining consistency in average scoring across all groups, even for individuals who do not possess the aforementioned

characteristics (Kleinberg, Mullainathan, and Raghavan, 2016, p. 2). This suggests that the average score for non-creditworthy women should align with the average score for creditworthy men. By extending fairness beyond the positive class, this condition seeks to rectify any potential biases against non-creditworthy individuals based on gender.

Importantly, Kleinberg, Mullainathan, and Raghavan (2016) highlight that the positive and negative class balance requirements can be seen as extensions of the principle that the relative amounts of false positives and false negatives (i.e., Type I and Type II errors) should be equal across both groups (Kleinberg, Mullainathan, and Raghavan, 2016, p. 2). While statistical parity demands equal average scoring across all groups for all members, the focus should be on achieving balance specifically for creditworthy and non-creditworthy individuals within each group. This distinction recognizes the need to account for differences in group compositions and the subsequent impact on fairness considerations.

Nevertheless, it is worth noting that fulfilling all three conditions simultaneously is often a daunting task. Trade-offs and choices inevitably arise, requiring a prioritization of which condition holds greater significance in a given context (Gandy, 2010, p. 39). Altman, Wood and Vayena (2018), in line with these considerations, argue that unless the probabilities of error are explicitly calculated for each group separately (such as for women and men), differences are likely to emerge (Altman, Wood and Vayena, 2018, p. 16). Implicitly or explicitly, the creators of the algorithm must deliberate on which types of errors should be minimized and which groups should be assessed with greater accuracy (Altman, Wood and Vayena, 2018, p. 17).

This essay centers on an examination of the discriminatory elements inherent in algorithms, employing a lens shaped by the two balance requirements outlined by Kleinberg, Mullainathan, and Raghavan (2016). These balance requirements specifically relate to the distribution of Type I and Type II errors. In the subsequent section, a detailed exposition will be presented, clarifying the precise nature and implications of Type I and Type II errors.

Exploring the Complexities of Type I and Type II Errors in Algorithmic Decision-Making

The assessment of creditworthiness is a binary classification task (Zliobaite, 2015, p. 6). In its simplest form, applicants are categorized into two classes: creditworthy or non-creditworthy, depending on their perceived ability to repay a loan. This classification becomes the pivotal point where the algorithm steps in, armed with its

complex calculations and predictive powers. The algorithm's goal is to make accurate decisions, minimizing the chances of errors that could lead to financial repercussions.

Type I and Type II errors serve as vital indicators of the fairness and accuracy of algorithmic systems. Type I errors, often referred to as false positives, occur when the algorithm wrongly identifies an individual as possessing a specific characteristic or falling into a particular category (Florez-Lopez, 2010, p. 494). In the context of creditworthiness assessment, a Type I error would mean labelling an individual as creditworthy when in reality they are not likely to repay a loan on time (Li and Zhong, 2012, p. 187). On the other hand, Type II errors, known as false negatives, happen when the algorithm incorrectly fails to recognize a characteristic or category that an individual genuinely possesses (Florez-Lopez, 2010, p. 494). For instance, a Type II error might involve deeming an individual as non-creditworthy, despite their high likelihood of timely loan repayment (Kern, 2017, p. 4).

By examining the distribution of these errors, we gain insights into the potential biases that algorithms can perpetuate. If there is an imbalance in the distribution of errors between different groups, such as women and men, it raises concerns of fairness and discrimination. For instance, if the algorithm consistently makes more Type I errors for women compared to men, it implies that women might face unjust disadvantages in accessing credit, despite their creditworthiness. Similarly, if the algorithm commits more Type II errors for men, it suggests that men might encounter challenges in obtaining credit even when they are creditworthy.

From Bias to Balance: Measuring the Performance of the Algorithm

Binary classification tasks such as creditworthiness assessment can be evaluated using various metrics to gauge their success and identify potential errors. Sensitivity and specificity are two key metrics that provide valuable insights into the algorithm's performance and its ability to accurately classify applicants (Sharma, Yadav & Sharma, 2009, p. 53).

Sensitivity, also known as recall or true positive rate, provides insights into how well the evaluation method correctly identifies creditworthy applicants when they are indeed creditworthy. It answers the question: How often does the system make the right call? To obtain the sensitivity value, we divide the number of true positive assessments (correctly identifying creditworthy applicants) by the sum of true positive and false negative assessments. High sensitivity indicates that the algorithm correctly identifies a large proportion of creditworthy applicants, minimizing the chances of Type II errors—incorrectly

classifying a creditworthy applicant as non-creditworthy (Sharma, Yadav & Sharma, 2009, p. 58). In essence, high sensitivity suggests that the algorithm is doing a good job of capturing and acknowledging the creditworthiness of individuals.

It is imperative to establish a robust and reliable assessment process that incorporates both sensitivity and effectiveness in differentiating creditworthy individuals from non-creditworthy ones. Merely prioritizing high sensitivity is insufficient to ensure the accuracy and success of the evaluation process. What we truly require are algorithms that strike a nuanced equilibrium, accurately identifying applicants who are creditworthy while also effectively recognizing those who may present a potential risk. This delicate equilibrium is the cornerstone of responsible lending practices, enabling the efficient allocation of resources and fostering the sustainability of the financial system.

To achieve this delicate balance, algorithms must take into account a range of factors beyond sensitivity alone. Specificity, a complementary measure to sensitivity, assumes a vital role in this equation. Also known as the true negative rate, specificity measures the algorithm's ability to correctly identify non-creditworthy applicants (Sharma, Yadav & Sharma, 2009, p. 58). It ensures that the evaluation process is not overly lenient, shielding non-creditworthy individuals from undue risks. By dividing the number of true negative assessments (correctly identifying non-creditworthy applicants) by the sum of true negative and false positive assessments, we can gauge the specificity of the algorithm.

To maintain the integrity of the creditworthiness assessment procedure, it is essential to strike a balance between sensitivity and specificity. A high sensitivity ensures that deserving creditworthy individuals are not unjustly denied opportunities, while a high specificity safeguards against the indiscriminate approval of non-creditworthy applicants (Sharma, Yadav & Sharma, 2009, p. 55). The interplay between these two metrics establishes a robust and reliable evaluation process—one that can be trusted by both lenders and applicants alike.

Dissecting Gender Disparities in Credit Repayment: Unravelling the Role of Gender in Algorithmic Scoring

The main premises in this essay are that gender serves as a predictor of credit repayment probability, and that the removal of gender scoring would introduce gender-specific implications concerning the occurrence of Type I and Type II errors. The ensuing discussion offers a succinct justification for these underlying assumptions.

Gender-based algorithmic scoring presupposes that certain

characteristics associated with gender—whether cultural, social, or economic—play a role in determining an individual's creditworthiness. Over the years, various studies and investigations have shed light on the disparities in payment behaviors between genders. These findings consistently highlight that men tend to have a higher incidence of payment defaults compared to women (Guérin et al., 2011, p. 8; Karlan & Zinman, 2009; Majamaa, Lehtinen & Rantala, 2019, p. 236). Such empirical evidence underscores the importance of understanding these differences and their potential impact on creditworthiness evaluations.

It is therefore crucial to unravel the complex web of factors that contribute to this association and explore whether it solely reflects men's poorer creditworthiness or stems from other underlying dynamics. This association can be attributed not necessarily to men's inherent creditworthiness deficit, but rather to factors such as their potentially greater utilization of credit services in comparison with women. This difference in credit usage patterns can contribute to their overrepresentation in indebtedness datasets. It does not necessarily imply that men are inherently less creditworthy, but rather that their credit behavior and utilization may differ from that of women. When individuals have a greater reliance on credit, it naturally follows that instances of repayment difficulties may also be more prevalent. Nonetheless, considering these factors, it can be posited that the overrepresentation of men in indebtedness datasets provides some indication that gender is potentially associated with creditworthiness, particularly within the subset of individuals who actively seek credit.

When discussing gender differences, even at their best, these differences are typically average and often have very small effect sizes. Individuals within each gender span a wide spectrum of behaviors and characteristics. However, removing the gender variable from creditworthiness assessment can present challenges, even if the repayment probability is identical for both women and men. To illustrate this point, consider the hypothetical scenario presented by Elliehausen & Durkin (1989) within the credit card market where an equal distribution of individuals with exceptional creditworthiness exists among both women and men (Elliehausen & Durkin, 1989, p. 100). Moreover, the hypothetical assumes that the lender has identified years of employment as a reliable indicator of creditworthiness. However, an intriguing observation emerges as it becomes apparent that creditworthy women, despite possessing similar creditworthiness to their male counterparts, tend on average to have fewer years of employment.

In this scenario, the number of years of employment serves

as a signaling variable for creditworthiness. However, the informational value of this variable differs between genders. A lower number of years of employment for women could indicate the same level of creditworthiness as a higher number of years for men. Thus, the assessment of creditworthiness would become dependent on gender in addition to the signaling variable, even if the predicted variable (average creditworthiness) is identical between genders. Consequently, removing the gender variable from the equation could potentially result in creditworthy women facing greater challenges in obtaining credit compared with equally creditworthy men.

These considerations form the basis of the underlying assumption in this essay: achieving a balance between Type I and Type II errors in lending would be difficult, if not impossible, without the inclusion of a gender variable. It is crucial to understand the implications of this assumption while interpreting research results and engaging in discussions surrounding gender-based algorithmic scoring in creditworthiness assessments. The inclusion of gender allows for a nuanced understanding of creditworthiness, taking into account the different contexts and characteristics that may influence repayment behavior.

Conclusion

At the outset of this essay, the following hypothesis was formulated: the prohibition of gender scoring in algorithmic decision-making may not effectively address discrimination. As the analysis progressed, this initial assumption underwent a process of refinement. It became increasingly apparent that the prohibition of gender scoring might unintentionally hinder the progress towards gender equality objectives. Consequently, there emerged a pressing need to explore an alternative framework for conceptualizing algorithmic bias, thus necessitating a fresh perspective to guide and shape the investigation.

The primary research question sought to identify a more robust approach, beyond the sole emphasis on input variables, for defining algorithmic bias in the lending context. In addressing this question, a review of the existing literature yielded a proposal for a more comprehensive approach to evaluate algorithmic bias. Rather than solely focusing on the selection of input variables, the suggested approach entails examining the distribution of error types across genders. This alternative perspective aims to encompass both the similarities and differences between genders, acknowledging the significance of equitable creditworthiness assessments for all applicants. By defining discrimination based on probabilities of errors, the objective is to ensure that evaluations are conducted with equal rigor for both women and men, thereby mitigating

the disproportionate impact of adverse outcomes.

Of course, it is imperative to acknowledge the compelling arguments supporting the prohibition of gender scoring. Among these arguments is the emphasis on averting the reinforcement of gender stereotypes within society. Additionally, there exists apprehension regarding the potential perpetuation of societal disparities between different groups through accepting differentiation. Furthermore, the inherent risk of erroneous calculations underlying scoring systems cannot be overlooked. However, within the framework of this essay, if the prohibition of gender scoring and the balancing of error probabilities are regarded as mutually exclusive scenarios, the prioritization of balancing error probabilities should be regarded as paramount. •

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Asymmetrical Access to Capital : Why Ethics Matters

Ethics & Trust in Finance
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Third Prize ex-aequo

Andrea Longton, CFA
United States
Senior Vice President, Opportunity Finance Network, Washington, DC ((United States)*

* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

If an ethical financial system is one in which no one is left out, then an unethical financial system is one in which certain groups are chronically disconnected from basic financial services.

In the United States, individuals who identify as Black, Indigenous, or People of Color (BIPOC) and households characterised as low-wealth are often shut out from mainstream financial resources.

This paper argues that asymmetrical access to capital is caused in part by a persistent gap between US financial regulations and a higher ethical standard. The paper calls for mainstream financial institutions to go beyond the baseline of legal compliance and adopt a more rigorous ethical standard to extend access to capital to historically underserved communities. Recognising that financial institutions and underserved communities have survived in separate financial realities for generations, the paper illuminates lessons learned from a network of community development financial institutions (CDFIs) which have demonstrated a successful track record driving affordable capital to BIPOC and low-wealth communities across the US. Finally, the paper recommends accountability measures to reinforce a long-term commitment to restoring ethical decision-making as it relates to financial inclusion.

Asymmetrical access to capital

With notable exceptions, financial professionals and institutions operate within the bounds of legal frameworks. US regulations like

the Equal Credit Opportunity Act and Fair Housing Act (together known as the Fair Lending Laws) and the Community Reinvestment Act are designed to intentionally guide the financial system towards the ethical outcome of financial inclusion. Despite well-conceived rules and a legislative infrastructure, relying on a regulatory framework to enforce ethical behaviour has been insufficient to establish equitable access to capital in the US.

In a 2020 study "Double Jeopardy: COVID-19's Concentrated Health and Wealth Effects in Black Communities," Federal Reserve Bank of New York economists Claire Kramer Mills and Jessica Battisto reveal the current-day inequities in access to capital: fewer than 1 in 4 black-owned employer firms had a recent borrowing relationship with a bank. This number drops to fewer than 1 in 10 among black non-employer firms, compared with 1 in 4 white-owned non-employers.

The funding gaps are not due to differential rates in black firms applying for financing. In fact, Mills and Battisto's (2020) evidence indicates that black-owned firms apply for financing at equal or higher rates than white-owned firms but are rejected at higher rates. Black business owners are also more likely than white owners to report being discouraged from applying for financing, or not applying because they believe they will be turned down. Among black employer firms, 37.9 per cent reported being discouraged, compared to 12.7 per cent of white-owned firms.

Mills and Battisto (2020) indicate that factors beyond a firm's financial health play a significant role in accessing mainstream – and affordable – financing. When controlling for just those firms that are healthy or stable, there continue to be sizable differences between black- and white-owned firms in bank funding. Most notably, 54 per cent of healthy or stable white employers have an existing banking relationship, compared to 33 per cent of healthy or stable black employers.

In the US, something other than the underlying credit of black-owned firms blocks them from accessing credit from a mainstream bank.

The 2020 findings are not a fluke incidence or recent development. BIPOC and low-wealth communities have been systematically blocked from the basic financial resource needed to preserve and grow wealth: access to credit. This inability to access credit has directly contributed to a severe racial wealth gap in the US (McCargo & Choi, 2020). By 2016, the median white family in America had more than ten times the wealth of the median black family (Noel, Pinder, Stewart III, & Wright, 2019).

This paper argues that the asymmetrical access to capital is caused in part by a persistent gap between US financial regulations and the higher ethical commitment to morally correct business decisions.

Legal behaviour is not necessarily ethical behaviour

Legally-compliant behaviour is not necessarily ethical behavior. While legal behaviour can be described as compliance with rules and regulations, ethical behaviour can be described as conduct that is morally correct (CFA Institute, 2019). Ethical principles are especially important in money-centred institutions because they prescribe appropriate constraints on a natural tendency to pursue self-interest that could harm the interests of others.

Finance professionals have outsized influence in determining the flow of capital and its materiality in the financial health of others. Maintaining regulatory compliance is insufficient to upholding their role in promoting the integrity and viability of global capital markets for the ultimate benefit of society.

Because regulations cannot address an exhaustive list of unethical behaviours, financial institutions must endeavour to inject frameworks of ethical behaviour into their core business models. As a rule of thumb, when faced with a choice between what meets the compliance baseline and what is morally correct, commitment to ethical behaviour requires an individual or institution to decide in favour of the morally correct route.

This paper calls for financial institutions to go beyond the baseline of legal compliance and adopt the more rigorous ethical decision to extend access to capital to historically underserved communities.

Illustrative examples of the gap between legal requirements and ethical behaviour

In order to restore an ethical financial system in which no one is left out, financial professionals and institutions must acknowledge the industry's historical role in disconnecting BIPOC and low-wealth communities from the access to capital needed to preserve and grow wealth on the same trajectory as US households which were able to thrive in the financial mainstream. Otherwise, conventional financial institutions will be unable to appropriately understand and address the asymmetries in the financial backgrounds and credit profiles of existing and prospective borrowers.

This section argues that the asymmetrical access to capital is caused in part by a persistent gap between US financial regulations and a higher ethical standard. While financial institutions may uphold the letter of US Fair Lending Laws, there is clearly a gap between legal compliance and the ethical principle that all people, regardless of demographic identification, deserve access to capital.

Throughout its history, the US financial system has continually exhibited its propensity for robust and rapid growth by quickly establishing

systematic infrastructure in response to promising market opportunities. While the financial market has evolved rapidly, corresponding US regulation has moved like cold molasses poured from a glass jar. Even after regulation has been approved, a general lack of resources to enforce well-conceived rules means that financial institutions have been able to find legal workarounds for ethically-questionable behaviour.

This persistent, historical gap between financial regulations and ethical standards drives BIPOC and low-wealth communities further and further away from the mainstream financial system with each generation.

Even before the United States Declaration of Independence from Great Britain in 1776, the colonial financial system expanded and thrived in financing the slave-based economy; it even went so far as to pioneer asset-backed securities collateralised by enslaved people in the same way that today's banks issue mortgages backed by houses as collateral. If the enslaver did not repay a loan, the lender would take the enslaved person(s) listed as collateral to recover a portion of the unpaid principal balance. The market for enslaved people was very liquid, in that enslaved humans could be sold for cash at a local auction block (Caldwell, 2012). Asset-backed securities collateralised by enslaved people was legal but unquestionably morally wrong.

Another notable example of financial regulations falling short of ethical standards was the explicit integration of racial biases in government-approved underwriting policies from 1934 through the 1970s. To restore faith in US credit markets following the Great Depression, the Federal government hired Homer Hoyt, a respected economist at the University of Chicago, to develop the first national set of underwriting criteria – who is a good credit and who is not – for the new Federal Housing Administration in 1934 (Dedman, 1988). The year before, Hoyt had published a list of racial groups, ranking them from having a positive to a negative influence on property values [sic]:

[1] English, Scots, Irish, Scandinavians

[2] North Italians

[3] Bohemians or Czechs

[4] Poles

[5] Lithuanians.

[6] Greeks

[7] Russians, Jews

[8] South Italians

[9] Negroes

[10] Mexicans

The Federal Government's establishment of systematic underwriting policies and lending infrastructure helped save the collapsing housing market, but it largely excluded BIPOC neighborhoods from government-

insured loans. Those neighborhoods were deemed financially "hazardous" and coloured red on maps, a practice that came to be known as "redlining." Loan approval policies dictated that loans within redlined neighborhoods would be rejected, leading to a severe shortage of credit in geographic footprints with high percentages of BIPOC communities (Rothstein, 2017).

The final example is contemporary. In 2021, more than 90 per cent of top lenders in the United States rely on FICO® Scores, a credit metric derived from underwriting belief systems that systematically shut out BIPOC and low-wealth communities. In the United States, FICO® Scores determine if a person is considered for a mortgage to purchase a house, a student loan to attend school, or a loan from a hospital to affordably repay healthcare bills. FICO® Scores lubricate the entire US financial system and play a critical role in billions of lending decisions every year (Fair Isaac Corporation, 2021).

Payment history, which accounts for approximately 35 per cent of a FICO® Score, assesses whether an individual has made timely payments on past credit accounts and is a strong indicator of his or her capacity and willingness to repay future debts on schedule (Fair Isaac Corporation, 2021). While payment history is undeniably one of the most important drivers of credit prediction, FICO® Scores do not consider fundamental drivers of credit in BIPOC and low-wealth communities. For example, they do not include rent payments, utilities payments, or cell phone payments, which are all predictive metrics regarding a borrower's ability to repay a loan.

While use of these credit metrics complies with US regulation, FICO® Scores reinforce a vicious credit cycle where low scores keep certain communities from successfully applying for the mainstream loans whose successful repayment would improve their scores.

To create a financial system in which no one is left out, financial professionals and institutions must acknowledge and intentionally counter the industry's role in shutting out BIPOC and low-wealth communities from basic financial resources. Financial professionals must understand how people who have been living outside the economic mainstream are not uncreditworthy. Instead, they have credit profiles which can be accurately assessed through alternative lenses that account for their historical lack of mainstream financial resources.

Specialised credit skillsets for lending outside the economic mainstream

Recognising that financial institutions and underserved communities have survived in separate financial realities for generations, this section illuminates lessons learned from a network of community development financial institutions (CDFIs) which have

successfully adapted fundamental banking practices to accommodate US communities living outside the economic mainstream.

CDFIs are private financial institutions that drive affordable capital into BIPOC and low-wealth communities throughout the US. CDFIs operate as banks, credit unions, loan funds, and venture capital firms that have been certified as financially sustainable and having a forward impact by the US Department of the Treasury.

As depository institutions which follow the same regulations and Fair Lending Laws as their mainstream peers, CDFI banks and credit unions are successful in lending into communities historically discounted by the mainstream system. According to a 20-year longitudinal study, CDFI banks experience higher delinquencies but lower charge-off rates than their mainstream peers (Dopico, 2017). While a delinquency is a banking term for when a borrower misses a scheduled payment on the loan, a charge-off occurs when a bank determines that the borrower lacks the ability or willingness to repay the loan. The bank writes off the loan as a loss and the default history devastates the financial health of the borrower. The findings suggest that CDFI banks manage delinquencies rather than charging off sub-performing loans. In other words, CDFI banks manage to the success and financial health of their borrowers.

CDFIs understand that living outside the economic mainstream does not make a person uncreditworthy, but instead requires a specialised skillset for credit assessments and robust, responsive risk management. These community-centric lenders are successful because they know their communities and calibrate their banking tools to predict creditworthiness based on fundamental financial analysis, customer-friendly support, and a shared vision of mutually reinforced economic success.

Lesson 1: Deep knowledge of customers

CDFIs listen to the community and deliver financial products and services based on their needs. This fundamental Know Your Customer (KYC) approach is central to the success of both the borrower community and the financial health of the CDFI itself.

With the explicit assertion that the people who sit closest to the problem have the best insights to the solutions, CDFIs embed themselves in the community, conducting listening tours and reinforcing communication points in a continuous feedback loop.

The KYC feedback is leveraged to develop community-specific, culturally relevant financial products which organically fit local needs for sustainable financial health. At the same time, tailored loan products reinforce the capacity of the borrower to repay the corresponding debt service obligation, directly supporting the financial health of the CDFI.

CDFIs underwrite the success of the community, using their deep knowledge of their customer base to inform their internal infrastructure of client engagement, lending products, and risk management.

Lesson 2: Specialised credit assessment

CDFIs recognise that clients who have been shut out from mainstream resources will not display the credit profile typically manifested by individuals who have flourished due to a virtuous cycle of credit building and wealth creation. Instead, CDFI underwriters utilise their deep knowledge of the community to fundamentally understand the risks through a customer-friendly lens and predict the borrower's ability to repay the loan using fundamental financial analyses. Rather than relying on conventional credit predictors like FICO® Scores, CDFIs dig further to consider alternative, though no less predictive, metrics such as savings accumulation rates or an individual's history of making rent and utility payments.

In addition to identifying culturally relevant payment history indicators, CDFIs also approach loan security analysis through a customer-friendly lens. Whereas conventional underwriting formulas and policies often require "skin in the game" in the form of collateral and owner equity, CDFIs have found that these factors are not the best predictors of repayment in their markets. Inter-generational disconnection from mainstream financial resources means that CDFI clients often have less wealth and financial assets than typical borrowers at conventional financial institutions. As such, CDFI borrowers are unable to meet conventional security requirements that may range from cash, a personal car, or even their family house as collateral for a loan. Rather, CDFIs may work with local governments or private institutions to secure alternative credit enhancements to mitigate risk on a loan. In a particularly innovative, customer-forward example, Carolina Small Business Development Foundation, a CDFI in North Carolina, structures an "equity capture" feature into its borrower loans that finances the owner's equity contribution into a business loan. The equity capture's timing helps a borrower who does not have sufficient upfront equity to invest in the business at the start of the loan, and allows them to repay when the business realises increased cash flow resulting from the CDFI's capital injection.

Lesson 3: Portfolio management and loan servicing

CDFIs build on their deep knowledge of the community to establish risk management infrastructure that reinforces the borrower's capacity to succeed. After any loan closes, a portfolio management team manages all aspects of the loan's life cycle, including servicing, delinquencies, waivers,

amendments, and modifications. The CDFI monitors loan performance and the credit risk related to each loan by conducting site visits and periodic loan reviews. At the same time, CDFIs rely on a robust loan servicing infrastructure that leans on a high contact and collaborative partnership between the CDFI and its borrowers. Servicers manage billing, payment application and any immediate issues and questions from the borrower.

Consistent with a high touch, customer-friendly risk management approach, CDFIs mitigate payment risk through two primary pathways: payment automation and customer-conscious loan servicing.

- Whenever possible, CDFIs automatically establish automated clearing house (ACH) connections to transfer debt service payments directly from a borrower-designated banking account. The borrower and CDFI alike gain peace of mind that the debt service payments will be timely and accurate.
- CDFIs monitor incoming debt service payments to proactively prevent late payments. When a monthly loan payment becomes 15 days late, many CDFIs contact the borrower via phone to investigate the delay and support the borrower's timely payment. Otherwise, if a monthly loan payment reaches 30 days late, the borrower will have to catch up on payments by combining the prior month's payment with the current month's payment, effectively doubling the cash outlay in a single month. Because many low-wealth borrowers manage to razor-thin budget cushions, a catch-up payment can be financially devastating. CDFIs mitigate this risk by monitoring debt service and formalising high-touch customer-conscious servicing calls to eliminate the "catch up" payment before it rolls into the next month's payment.

Lesson 4: Compressed borrowing rates

CDFIs maximise value and wealth for their communities by driving cost savings to their borrowers in the form of compressed interest rates to the borrower. A compressed borrowing rate catalyses financial health in households where budgets are tight and financial health is precarious. In low-wealth communities, loan terms can make or break a family's ability to preserve and grow wealth.

In contrast to a system of predatory payday lenders who permeate the physical landscape of BIPOC and low-wealth communities, CDFIs compress their borrowers' interest rates to the lowest rate possible while still covering the CDFI's expenses. Whereas payday lenders or loan sharks take advantage of the lax regulatory environment to charge the maximum rate allowed under state law, CDFIs deepen affordability by offering loans at low interest rates, resulting in less expensive monthly debt service payments for the borrower. Imagine stretching your paycheck further with a 3 per cent mortgage rate versus a 20 per cent mortgage rate.

Lesson 5: Support during economic crises

CDFIs sustain and reinforce their client-focused support during economic crises. Known in the United States as financial first responders, CDFIs rush in to offer relief measures to borrowers impacted by external shocks.

During the financial crisis of 2008-2009, when the collapse of Wall Street's predatory subprime mortgages triggered a global economic recession, CDFIs supported their borrower communities by advocating for government support, raising and deploying survival credit, and when necessary, delivering payment relief options. Despite the severe headwinds of the 2008-2009 financial crisis, the CDFI industry grew substantially, delivering capital to low-wealth communities at the same time that mainstream lending institutions decreased lending and hoarded cash (Swack, Hangen, & Northrup, 2014).

Recommendations for accountability regarding financial inclusion

While CDFIs have demonstrated how to adapt fundamental banking practices to reach underserved communities, this paper calls for mainstream financial institutions to apply those same lessons to their own policies and practices. With $222 bn in industry-wide assets under management at the end of 2019 (Williams, 2020), CDFIs' capacity pales in comparison with mainstream financial institutions, the largest of which reported $3 trillion of assets under management as of April 2021 (Tor, 2021).

This paper responds to the commitments that many US financial institutions made in 2020 for racial equity and financial inclusion. Specifically, this section recommends accountability measures to rebuild a long-term commitment to restoring ethical decision-making in relation to financial inclusion. Reliance on legal compliance alone is insufficient to ensure ethical behaviour by financial professionals, let alone create a truly ethical culture in the industry. Only by applying strong ethical principles at every decision-making level will financial institutions build a financial system in which no one is left out.

Confront difficult issues with a culturally relevant board of directors.

Accountability requires leaders to confront difficult issues. Tackling the disproportionately high representation of white men on boards of directors is an extremely uncomfortable conversation for most US firms. While uncomfortable, financial institutions can establish accountability to financial inclusion by cultivating a board of directors whose lived experiences are representative of those of an expanded client base.

A board of directors that reflects the demographics of the expanded client base is more likely to hold the executive management team

accountable to its goals to expand reach into those same demographics. In addition to accepting the ethical premise that all people deserve access to capital, a board that shares the lived experiences of the expanded client base would intuitively understand the critical importance of approving policy revisions that accommodate the credit realities of communities which have been surviving outside the financial mainstream for generations.

A leadership team that is representative of the expanded client base will be better equipped to advise on culturally relevant topics than a homogenous team whose collective lived experiences are limited to those of the conventional client base. A board member who has never lived without access to mainstream financial resources cannot fully comprehend how someone living outside the economic mainstream may demonstrate their creditworthiness through unconventional credit metrics.

Focus on collective outcomes through key performance indicators.

A financial institution must be able to measure progress in order to manage it. To exceed expectations, it must incentivise progress.

Today's financial professionals face significant pressure to manage to the bottom line while upholding corporate goals of financial inclusion. When firms ask their employees to see beyond compliance baselines and identify innovative tools that assess unfamiliar clients, firms are asking employees to work against credit approaches which they have been trained to embrace as the gold standard. Employees are being asked to leave their comfort zones and be brave. To reinforce behaviour that works against muscle memory, financial institutions must integrate ethical decision-making into the company's formal performance management and compensation infrastructure. Without formal infrastructure that reinforces ethical behaviour, an outspoken commitment to financial inclusion is no match for the deluge of urgent decisions that financial managers make daily.

Specifically, financial institutions may adapt existing performance metrics, often referred to as key performance indicators (KPIs), to address financial inclusion goals. Just as scaffolding supports construction workers restoring a building, formal performance metrics that reflect financial inclusion goals support employees making decisions that initially feel uncomfortable.

Every US corporate employee is familiar with the universality of KPIs, or company-specific performance metrics that demonstrate how effectively an individual or institution is meeting its key business objectives. KPIs are one of the first things that employees learn about when they join a company and the KPIs are reinforced throughout their tenure. Each employee is asked to use KPIs

as the blueprint for the decisions they make during the workday and the approach they bring to their interactions with others. Successful employees integrate KPIs into daily decisions.

KPIs addressing financial inclusion should be explicitly stated and progress should be monitored as part of ongoing performance evaluations and compensation decisions. While each financial institution will have nuanced KPIs that best meet the financial needs of their existing and future clients, illustrative examples of financial inclusion goals include:

- Increased percentage of successful credit applications submitted by BIPOC clients vis-à-vis those submitted by white clients;

- Decreased percentage of BIPOC applicants discouraged vis-à-vis the percentage of white applicants discouraged.

One of the most effective ways to incentivise employees to meet and exceed their KPIs is to tie compensation to an individual's progress towards achieving their KPI benchmarks. Incentivised employees, including executive leaders, are far more likely to prioritise adequate energy and resources to successfully expanding the financial institution's reach into historically underserved communities.

By incentivising a focus on collective outcomes, financial institutions will hold leaders and employees accountable for their everyday decisions by connecting self-interest with ethical behaviour.

Force clarity and closure through transparent reporting

Many US financial institutions made outspoken commitments to financial inclusion in 2020 in response to political and consumer opinion that loudly expressed dissatisfaction with disparities within the US financial system. Publicly available, transparent reporting holds financial institutions accountable for their demonstrated willingness and capacity to walk the talk.

In the same way that financial institutions prepare earnings reports for financial results, financial inclusion reports track their progress in creating a financial system in which no one is left out. As a voluntary report, the financial institution retains the ability to tailor its reporting framework around a nuanced approach for meeting the specific needs of its expanded client base.

Financial institutions could follow the example set by Goldman Sachs, which released a culturally relevant Sustainability Report in April 2021. The report framed Goldman Sachs' commitment to its self-defined sustainability goals, reported related progress, and proactively improved its public relations image by defining its business purpose as sustainable economic growth and financial inclusion. This shrewd manoeuvre may satisfy Goldman Sachs' shareholders who, at the time of writing, are being asked to vote

against a racial audit of its business, a deep dive that would analyse how the US firm may have contributed to racial inequities in the US financial system (Abelson, 2021).

There is catalytic power in transparency, setting goals, and measuring progress. It enables a financial institution to bring its entire workforce and its shareholders along for the journey. Transparent reporting also signals a financial institution's willingness to lead with vulnerability and humility, even in politically charged climates.

Conclusion

For too long, BIPOC and low-wealth communities have been disconnected from the financial institutions that serve as the primary conduits of capital flow for US households. Today's financial services leaders have met this moment of US racial reckoning with renewed commitments to financial inclusion and have reinforced the ethical principle that every person has a right to access to capital.

This paper serves as a conversation-starter for financial institutions that are seeking ways to reach deeper into historically underserved communities. It also provides initial recommendations for reinforcing this commitment through structured accountability measures. Regardless of the specific approach adopted by each financial institution, a deep-seated commitment to building a financial system in which no one is left out is critical for a sustainable future. •

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Debt Cap Rules and Ethics: Balancing Stability and Inclusion

Ethics & Trust in Finance
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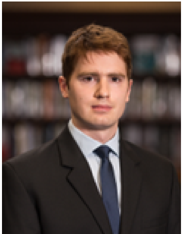
Finalist

Bálint Dancsik
Hungary
Head of Department
*Magyar Nemzeti Bank**
(the Central Bank of Hungary),
Budapest (Hungary)



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Financial crises have a long history where swindles and frauds feature strongly in the credit-fuelled "manias" which precede them (Kindleberger & Aliber, 2005). The meltdown after such crises reveals morally questionable practices, and those engaging in them – typically bankers – are brought to the forefront of public attention and academic analysis. However, this emotionally-heated dialogue blurs the lines between two distinct issues:

(1) how different financial institutions treat their own customers;

(2) to what extent individual banks are responsible for the outbreak of a financial crisis with severe macroeconomic consequences.

This paper focuses on the latter question.

The study argues that the decisions faced by financial institutions sometimes reflect the tragedy of the commons (Hardin, 1968), which is a metaphor for the conflict between individual and collective rationality. Just as the cattle in the analogy graze more and more of the pasture, increasing lending uses up more and more income in the economy. Just as it makes sense for individual herdsmen living around the pasture to send an increasing number of cattle to the field, under certain conditions the decision-makers at individual financial institutions may feel that lending more and more is rational, even if they have to loosen credit conditions to do so, thereby generating risks for the whole system.

In the aftermath of the 2007–2008 global financial crisis, it

has become a priority to prevent similar meltdowns. To this end, bank regulators have created a set of so-called macroprudential instruments. The most direct of these are debt cap rules, which explicitly state to what degree debtors can become indebted relative to their income or equity. The regulations prevent over-indebtedness among economic actors, thereby addressing the issue of coordination among banks and reducing the probability of financial crises. However, establishing the minimum requirements for these rules raises a new, truly ethical dilemma. The question arises as to where to draw the line and find the trade-off between ensuring financial stability and providing people access to credit.

The paper examines these problems. First, it is shown that – when driven by overlending – the emergence of macro-level financial imbalances is often analogous to the tragedy of the commons. This comparison seeks to show that the issue arises much more from a failure of "coordination" than from ethics. Following the same logic, the paper suggests why so-called debt cap rules that limit borrowing can address this issue of coordination, and thus respond to the new moral concerns raised by the introduction of such regulation.

Financial instability as a tragedy of the commons

Hardin's famous story (1968) has three crucial aspects that are necessary conditions for the emergence of the tragedy of the commons:

(1) The participants in the game have two choices ('A' or 'B'), which have different effects on the common-pool resource;

(2) Option 'B' exploits the resource more, but results in greater utility to the individual players, so it is always worth choosing it. But if everyone opts for Option 'B', then;

(3) they will be worse off collectively than if everyone had chosen Option 'A'.

The story is the perfect metaphor for the conflict between individual and collective rationality in certain decisions.

In our tragedy, the players are the banks, the common-pool resource is the income of economic actors (states, households, companies), and the decision is about the amount and the related riskiness of the loans made by the bank. To the best of the author's knowledge, the analogy of the tragedy of the commons appears in only a handful of papers on financial crises, and usually only as a passing remark, without a comprehensive assessment of the similarities. In the literature on financial stability, Borio, Furfine and Lowe (2001) and Rungcharoenkitkul, Borio and Disyatat (2019) mention it, while in the literature on business ethics de Bruin (2018) remarks on the tragedy, but he does so in connection with the bursting of housing market bubbles rather than in relation to lending.

To explain the parallel, three claims must be substantiated:

(I) Excessive lending compared to income increases financial instability;

(II) Financial instability entails high costs for the entire financial system and its institutions;

(III) Under certain external and internal circumstances, individual banks have the ability and willingness to tend towards a strategy of increased lending.

Too much credit results in financial instability

When lending, banks expect returns from the debtor's income. As the ratio of debt servicing to income increases, so does the debtor's riskiness. In good times, economic actors are prone to build up leverage. However, the higher the leverage, the smaller the shock necessary for debtors to fail to meet their debt servicing commitments. High leverage built up in good times leads to instability (Minsky, 1992).

At the macroeconomic level, gross domestic product (GDP) is a good proxy for aggregate income, while the leverage of the economy as a whole can be measured as the ratio of private sector credit to GDP. A rise in this indicator indicates an increase in the average relative indebtedness of economic actors. The Basel III accord developed by the Bank for International Settlements seeks to measure the financial cycle through the fluctuations in - or deviations from the trend of - precisely this indicator (BIS, 2010). If the credit-to-GDP ratio persistently deviates from its trend in a positive direction, so that credit steadily grows at a faster rate than income, it suggests overlending and thus could signal a risk.

The dangers of a high credit-to-GDP ratio are also confirmed by empirical research, because a rise in leverage can be observed before most financial crises. The majority of crises are "credit booms gone bust" (Shularick & Taylor, 2012), as attested by historical analyses going back centuries (Kindleberger & Aliber, 2005; Reinhart & Rogoff, 2009). Empirical analyses examining financial crises also highlight lending as the most important factor (Borio & Lowe, 2002; Drehmann & Juselius, 2013; Borio, 2014; Alessi & Detken, 2018), with overlending especially harmful when coupled with the evolution of asset price bubbles.

In summary, too much credit eats up the income of economic agents, just as too many cattle exhaust the resources of the pasture. Experience has shown that too much credit relative to income often leads to a banking crisis. Of course, it is important to determine what amount of credit is too much. One difference compared to a textbook tragedy of the commons, which is practically an n-person prisoner's dilemma, is that while every new animal grazing the pasture reduces the position of the other herdsmen, lending is not harmful up to a

certain point, and in fact can have a particularly positive effect on economic growth (Levine, 2005). Nevertheless, it is not different from a real-life tragedy of the commons: in reality, sending out new cattle does not create negative external factors up to a certain number of livestock, as the pasture usually provides enough food for more animals to reach their maximum size for slaughter . In reality, the pasture only becomes saturated beyond a certain point, when the negative external factors take hold, in the same way as overlending in the financial system.

Overlending can have a disastrous effect on the whole financial sector and the wider economy

Banking crises are costly. According to Laeven and Valencia's database (2018), the median loss in output due to systemic banking crises between 1970 and 2017 was 23 per cent; (meaning that at the end of the third year following the crisis, actual GDP had a cumulative lag of this amount behind the estimated GDP value estimated based on the pre-crisis). The highest median share of non-performing loans on banks' balance sheets was 26 per cent. Fiscal costs directly related to the restructuring of the banking system amounted to 9 per cent, or net 6 per cent of GDP. Management financial crises in the broader sense also entails costs, which increases government debt, potentially leading to a sovereign debt crisis (Reinhart & Rogoff, 2011; Acharya, Drechsler, & Schnabl, 2014).

Systemic banking crises also have a detrimental effect on the players in the financial system. In the wake of the 2007–2008 crisis, multiple institutions failed or were forced into mergers or acquisitions to avoid bankruptcy.

Banks are able and eager to lend during booms

Although macroeconomics textbooks tend to present banks as mere intermediaries, banks do not in fact lend out deposits: on the contrary, they create deposits by lending (McLeay, Radia, & Thomas, 2014; Werner, 2014; Ábel, Lehmann, & Tapaszti, 2016). If a bank finds an opportunity for lending that is profitable enough (or at least appears to be), it can conclude the deal even in the absence of the necessary liquidity and then turn to the interbank market or the central bank for funds. Of course, this does not mean that banks can create an infinite amount of loans (money). The development of lending and bank balance sheets is also constrained by prudential regulation (Xiong, Wang, Wang, & Stanley, 2020). It is no coincidence that the techniques and innovations that financed the credit boom before the US subprime crisis partly sought to circumvent precisely these limits, such as securitisation. An interesting parallel with common-pool resources is that in tragedy-

of-the-commons situations related to natural resources, these are often depleted by rapid advances in technology; for example, when a lake's fish stock is exhausted due to the sudden appearance of motorboat fishing (Ostrom, 2000). Innovations in banking allowed credit institutions to encumber the income of private sector players with debt faster than before.

Banks can create too much credit, when the level is seemingly warranted by individual bank strategies to bolster profitability prospects. In this context, what are the factors which can prompt banks to fuel overheating during a credit boom?

Competition, innovation, and market pressure

Banks strive to innovate, secure new markets and move ahead of their peers. In the US, one such innovation was the servicing of a huge number of subprime debtors which spread the resulting debt through securitisation. Other institutions were forced to adopt successful strategies, or those that temporarily seemed to be so, in order to avoid losing market share.

Conformity, groupthink, and peer pressure

Another important factor is the imitation or conformity observed among institutions and experts. Conformity is not exclusive to financial companies; it can be observed anywhere in the economy. Warren Buffett refers to these "lemming-like tendencies" as an institutional imperative, during which "the behaviour of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated" by market participants (cited in Hagstrom, 2005, p. 97). This is because corporate leaders are "unwilling to look foolish" and fall behind other firms, even if these competitors "are heading to the sea" in the medium term. The same is stressed by Lámfalussy (2008), clearly in relation to the financial system: "the greater the competition, especially by famous competitors, the stronger the urge to use the behaviour of the majority as a benchmark to measure manager performance. An error committed by everyone is considered less grave than a 'lonely' one" (Lámfalussy, 2008, p. 91).

Executive payments

Prior to the subprime crisis, volume-based compensation packages rewarding short-term performance were widely used. DeYoung, Peng, and Yan (2013) point out that bank executives whose compensation depended more on the volatility of the bank's share price (i.e. those whose compensation packages included a large share of stock options) were more likely than their peers to engage in riskier and more innovative activities to boost profits.

Soft budget constraint and moral hazard

Moreover, risky decisions had asymmetric consequences: in a boom, the profits went to the financial institution's employees and shareholders, while the bill was often picked up by the state and ultimately the taxpayer after risks surfaced and financial strains appeared,. This "too big to fail" attitude resulted in a soft budget constraint for financial institutions (Kornai, Maskin, & Roland, 2003), thereby contributing to the distortion of banks' behaviour through the changed consequences ("payoffs") of their decisions.

A failure of coordination, not ethics

The factors discussed above all reduce clarity in terms of ethics during a credit boom. The negative consequences of individual lending decisions do not appear immediately, while their positive effect is clear. During a boom, it is the avoidance of risky lending that can be viewed as unethical by the bank and its employees. This is because the institution would deny the realisation of debtors' "dreams" in a market where the economic outlook and the availability of funds seem to support it. For example, in the years leading up to the subprime crisis, 12 million Americans purchased their own homes (Gramlich, 2007) and many of them were able to later service their debts.

Despite the subsequent economic meltdown, the ethical consequences of a decision are difficult to assess, even at the micro level. Banks and bank administrators cannot necessarily be expected to assess macro-level consequences, as these are also difficult to measure (de Bruin, 2018).

However, this paper does not focus on micro-level ethical problems in financial crises. Instead, it concentrates on the relationship between individual financial institutions and the financial system as a whole. This connects it to several earlier studies. Herzog (2017) discusses the "public good" issues of sectors with competing companies, underlining that firms are in strategic interaction, to employ a term from game theory. Herzog (2019) specifically examines the systemic harm caused by banks, concluding that individual institutions disregard social interests, due to epistemic, motivational and coordinational reasons. Moggia (2021) analyses the systemic issues in the CDS market and reaches a similar conclusion when noting that consideration of moral aspects is difficult for individual institutions for three reasons. First, the ethical assessment of probabilities is problematic in itself, creating a "problem of paralysis" and "problem of fairness" (see also Hayjenhelm & Wolff, 2011); second, in most cases the influence of individual market participants on system-wide stability is marginal; and third, market participants have limited knowledge of the system-wide consequences

of their actions. De Bruin (2018) also concludes that nobody can be blamed for large-scale events such as financial crises.

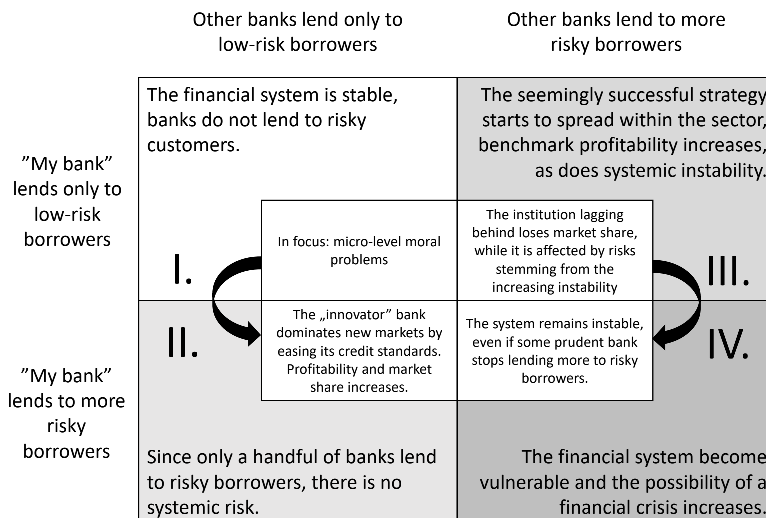
The dynamics of the tragedy in banking

These findings are completely consistent with the analysis in this study. The tragedy of the commons is a metaphor for situations where individual players ("any bank") typically cannot break out on their own, because even if they made a cooperative decision, it would not have a clear-cut positive outcome for the system as a whole. If a bank decides to cut its credit supply during a credit boom, the resulting vacuum can easily be filled by a competitor, thereby rendering the efforts of the former superfluous. Under such circumstances, the strategy of lending may dominate over the strategy of non-lending (Figure 1).

In the chart below, the inner rectangles detail the motives of individual banks, while the outer rectangles describe the state of the system. Under certain circumstances, specific institutions always find it worthwhile to open up towards risky debtors, regardless of the lending practices of other banks. Outcome II is better than Outcome I, and Outcome IV is better than Outcome III. Risky lending dominates over prudent behaviour.

It is no coincidence that in order to overcome the issue of coordination, Herzog (2019) suggests the creation of "associations" in which market

Figure 1. Financial instability as a tragedy of the commons during a credit boom



Source: Author's compilation.

participants and regulators can identify market failures and agree on the forms of behaviour to be avoided. Ostrom (1990) also points out that a large portion of common-pool resource issues can be solved by participants themselves; for example through non-state institutions established by them, such as the associations proposed by Herzog.

However, the author believes that this suggested solution is problematic in several respects for bank lending. First, the market has too many participants, and the above-mentioned "internal" solutions are mostly able to work with smaller communities. Second, there are typically many different interpretations of the factors creating a credit boom (Shiller, 2019), so not everyone may associate the developments with instability. Third, communication, mutual decisions and "cooperation" among competitors is closely watched by the competition authorities, and therefore cooperating market participants are likely to face penalties.

If we accept that the emergence of a financial crisis can be considered a market failure out of which individual institutions find it difficult to escape, regulators are responsible for addressing this failure. However, this raises other dilemmas of a truly ethical nature.

Debt cap rules and ethics

Regulators have done much in recent years to manage the failure in coordination discussed above. The existing rules on banks have been tightened, and several new, so-called macroprudential rules have been introduced. These partly serve to prepare banks to weather systemic risks and include countercyclical capital buffers, capital conservation buffers, and liquidity rules. They are also partly designed to prevent the over-indebtedness of borrowers, especially households.

The debt cap rules used to achieve these goals can take many forms. For example, they can regulate the loan amount relative to the value of the property to be purchased (the loan-to-value rule), thus effectively prescribing a minimum own contribution for future debtors. They can also establish constraints in relation to debtors' income, such as by capping the ratio of instalments and monthly income (the payment-to-income rule) or of income and the loan amount (the loan-to-income rule).

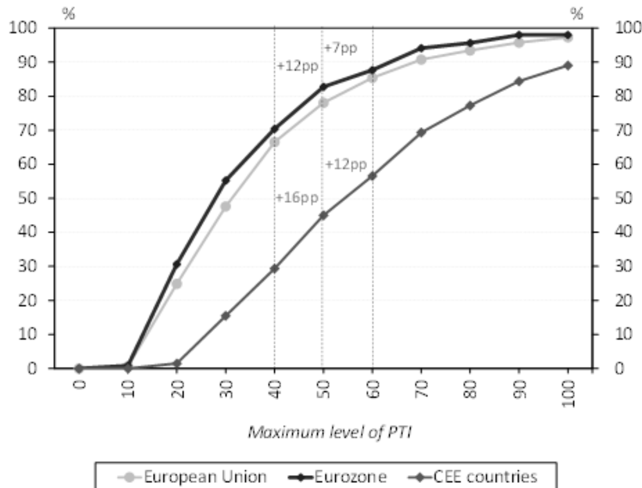
These rules considerably enhance the system's financial stability. They are tantamount to placing restrictions on the herdsmen in the tragedy of the commons regarding the maximum number of cattle allowed on different parts of the pasture, thereby addressing the issue of coordination. Individual constraints on herdsmen can prevent the overuse of the pasture, just as debt cap rules can prevent a certain amount of income from being burdened by too much leverage.

Unintended consequences of the regulation

However, one adverse side effect is that the rules determine at the same time whom to exclude from the credit market or its specific segments. Depending on their form, debt cap rules determine the maximum loan amount for a specific level of income, indirectly determining the maximum size and quality of the properties that debtors can plan to purchase. The loan-to-value rules govern the size of a borrower's own contribution, thus determining the number of years he or she will need to save before buying a given home.

What does this mean for example in the European Union? Figure 2 shows a schematic estimate of the number of people within the population of the EU who could take out a loan to finance the purchase of a 50-square metre home in the capital of their country, given various payment-to-income (PTI) limits. The countries are highly heterogeneous from this perspective, since the calculation is influenced by income inequalities, the typical composition of households, the housing loan rates characteristic of the countries and property prices in the capital. Our simple calculations show that if a macroprudential regulator sets the PTI cap at 40 per cent instead of 60 per cent, that may exclude close to 20 per cent of households from purchasing their desired home. Regulation has an even greater effect in the central and eastern European region. Of course, this is an extreme scenario, with credit terms which are in part arbitrarily selected. They would only be realistic if banks were

Figure 2. Share of households which can afford a 50-square metre flat in the capital financed from borrowing, with different PTI limits



Source: Source: Own calculations, Eurostat (EU-SILC), Numbeo.com, ECB .

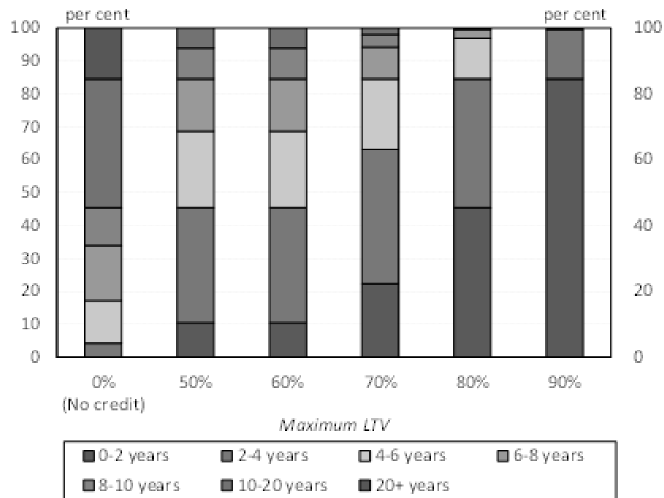
willing to lend at any PTI limit, and the only restraint on borrowing was regulation.

The calculations in Figure 2 were based on average prices per square metre in the capitals of individual countries. The author examined the number of households which can pay the instalments of a 30-year loan with an LTV of 70 per cent in the context of the average housing loan rates in individual EU countries and the income distribution of households in the given country (down to deciles), while also respecting the various PTI limits. All household deciles were assumed to have income at the top of the given decile (for example, at the 10th percentile in the 1st decile), with the exception of the top decile, where the income of the decile members was assumed to be the income at the 95th percentile.

The LTV limit influences the time necessary for the borrower to accumulate their own contribution for the home purchase. Examining the issue with regard to the European Union: Only 34 per cent of households could accumulate their own contribution for purchasing a 50-square metre flat in their country in less than four years with an LTV limit of 50 per cent, assuming that they saved all of their income for this purpose . With an LTV of 70 per cent this share was 63 per cent, and with an LTV of 90 per cent it was close to 100 per cent (Figure 3).

Figure 3 shows the distribution of EU households based on the number

Figure 3. Time necessary to accumulate one's own contribution for purchasing a 50-square metre flat in EU capitals, with different LTV limits



Source: Own calculations, Eurostat (EU-SILC), Numbeo.com, ECB

of years it takes them to save all of their income to accumulate their own contribution for purchasing a 50-square metre flat in the capital. The same weighting applies to income distribution as in Figure 2.

The dilemma

A large portion of the debtors excluded due to debt cap rules could make payments and the income of many of them would not contract considerably even in a subsequent recession. However, it is difficult to identify these debtors precisely or who would fail to qualify, using currently available information. Banks and regulators use probability models to estimate default rates, but in the case of households these provide useful information for the population (the portfolio) as a whole rather than for individual households. Therefore, macroprudential regulation inevitably excludes some debtors who would be eligible for loans, because it is safer for the system overall if loans are not extended to them.

The above calculations are admittedly schematic and arbitrary, but they highlight the problem: depending on the calibration of debt cap rules, certain social groups are excluded from the credit market or they need to settle for smaller loans and homes. This is despite the fact that many households should be more indebted based on expected future income. For example, the problems detailed above are particularly difficult for young adults, as their income is generally the lowest, while their expected wage growth is among the highest, and the amount of available savings (their own contribution) is also typically low. According to the life-cycle/permanent income hypothesis (Modigliani & Brumberg, (1954) and Friedman (1957)), they should expand their consumption and investments with substantial borrowing.

Since this is essentially a probability issue, rights-based ethics offer little guidance in its assessment (see Moggia, 2021). These ethics can better decide yes-no questions; for instance, is it ethical to offer loans or not? However, they cannot provide an adequate answer as to whether 30, 40, 50 or 51 per cent is the ethical limit for the PTI. The choice of the regulatory limit is inevitably arbitrary, and it is almost certain that some debtors will be excluded "without grounds" from among those eligible for loans. In fact, the missing (but not risky) borrowing also reduces economic growth and is thus harmful to society.

Ethics based on a cost–benefit analysis is more useful for such problems. This approach still has problems, such as the problem of fairness (Moggia, 2021). From the perspective of outcome-based ethics, it is clearly easier to argue that introducing rules is positive and ethical, as although it excludes some people from accessing the appropriate loans, it saves society

from a much greater "utility loss" by preventing financial crises. But here the question also arises as to what extent the economic benefits can be aggregated with the utility caused by the "happiness" of the people acquiring their own home. Our models can only capture the former: they can examine whether one unit of additional lending is probably harmful or beneficial for the *economy*, taking into account the effects on GDP.

In short, a merely theoretical approach will probably not determine the ethical level of debt cap rules. There is, however, something that can definitely be done: people who are the "exceptions" can be identified, who may violate the rule without affecting the systemic risk but still increasing their own utility. Overall, undifferentiated debt cap rules point in the right direction, but we should still think about enhancing them and improving the trade-off between financial stability and inclusion.

Outlook – how to improve?

The author does not wish at all to suggest that the introduction of debt cap rules was misguided. These rules ensure the stability of the entire system, making them particularly useful in preventing future financial instability. However, the same rules have unintended consequences, and one should consider how to improve their management, without undermining their original purpose. I believe that this is the best way to resolve, or at least ease, the ethical dilemma described above.

Be better at finding those who actually default

Debt cap rules are necessary because it has detrimental effects on the entire system if loans are disbursed to too many debtors with an overstretched income. However, it would be easier to determine whom to exclude from lending, and who was eligible for larger loans despite their current low income or wealth if more information were available on the debtors who will not be able to make payments, rather than general statistical data for households as a whole or certain parts of it. Probability of default (PD) models constantly evolve, and the databases that can be used are also expanding. This allows the default risks of individual debtors to be assessed more accurately, even using alternative methods besides traditional credit scoring (see for example, Berg, Burg, Gombovic, & Puri, 2020). The state also has a role to play here in maximizing the data and databases that are available to lenders to make the assessment of credit risks increasingly accurate; for example, by expanding the information available in credit registers.

Of course, this is only useful up to a certain point. The information that can potentially be collected on debtors is vast, but privacy considerations raise other serious ethical issues.

Make better estimates of the optimal level of debt cap rules

To balance the beneficial and detrimental effects of lending, it is vital to gain an accurate picture of the exact limit that prevents the evolution of financial instability while minimising the unintended consequences of the regulation.

Enable and support cost-reducing innovations

In the context of sufficiently intense competition, the reduction in the costs of financial intermediaries is also reflected in falling prices (i.e. interest rates). Other things being equal, lower interest rates allow a wider group of society to access the desired loans. The innovative firms and solutions that appear in lending can thus significantly expand financial inclusion.

Use other tools to compensate excluded potential debtors who nevertheless pose a lower risk

If social groups can be identified where debt cap rules make borrowing especially difficult even though the long-term risk of the group is lower, the exclusion of these households from the credit market can be mitigated by other government instruments. Possible solutions include state subsidies such as financial guarantees on own contributions for young employees, interest subsidies or making the cost of borrowing tax deductible.

Differentiate between debt cap rules

Social groups which maintain a lower risk profile even with higher PTI and LTV limits should be identified and supported, and they should be allowed to borrow more freely. Young people who are first-time home buyers could receive financial loan support, as is the case in several EU member states. For example, a higher LTV can be used for first-time home buyers in Finland, Ireland, Malta and Romania and in the Czech Republic and Estonia, even without specifying a social group and only determining a specific share of banks' portfolio (ESRB, 2020). In the latter case, it is the banks' responsibility to identify the debtors who do not pose extreme risk even with a higher LTV. However, this option is capped.

In conclusion, this study argues that the lending activities of individual banks sometimes follow the logic of a tragedy-of-the-commons situation, and that the emergence of financial instability is a coordination issue, rather than an ethical one. After the 2008 financial crisis, regulators took several steps to prevent the evolution of similarly devastating crises in the future. Debt cap rules effectively limit the debt accumulated by private sector actors, keeping it at a healthy level relative to income. However, these rules also exclude parts of society from borrowing who could be good debtors and would not significantly increase systemic risk.

It is our shared responsibility to find these groups and strike an even better balance between financial stability and financial inclusion. •.

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Ethical Pathways to Reduce Africa's Sovereign Debt

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Finalist

Anazuo Saadat Salihu
Nigeria
Lecturer, Kogi State University, Anyigba, Kogi State (Nigeria)*

* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

The 1st century essay *De Beneficiis* by the Roman philosopher Seneca the Younger can be regarded as a simplistic but classic evaluation of the complex nature of debt diplomacy and all the ethical questions it raises. In his opening statement, Seneca stressed that people do not know how to give and receive benefits. Other questions that were explored relate to the following:

- In book six, there is the question of whether a benefit that has been provided can be forcibly taken away by the benefactor at his discretion.
- In the seventh book, the concluding statement asks whether a debtor who is doing everything in his power to repay a debt should be treated in the same manner as another debtor who has not made efforts to repay his own obligations.
- In the second book, Seneca uses anecdotes to suggest that benefactors who demand accountability and transparency are not beneficial to the debtors, but rather, are shaming them.
- Along the same lines, it is emphasised that a benefactor should not give what would harm a receiver. The author in fact specifically stresses that "I never will give money to a man if I know that he will pay it to an adulteress" (XIV, Book II)… nor be connected to evil by assisting him to perpetuate any act of wickedness (Stewart, 2009).

A Twitter friend of the author of this essay recently expressed a similar sentiment to the one that is implied in the last point above. He

tweeted that he foresaw a situation where an African country could sue its international creditors which continued to lend to the country despite its inability to pay back the loan. A Twitter follower of my friend expressed skepticism at this argument. However, my friend responded that this could happen in the same way that a drunk can sue a bartender who sells more beer to him when he is already inebriated. The Twitter friend based his hypothesis on the United States' Consumer Finance Protection Bureau's "ability to pay" rule which compels mortgage lenders to establish that a borrower can in fact bear the financial obligations of a mortgage before granting a loan (Aja, 2021).

Within this ethics bound community of shared interest, one question takes precedence: How can sovereign debt finance achieve sustainability with shared interests despite the ethical dilemmas which these interests generate?

To clarify, this essay is about the debt crisis that afflicts African countries, especially as it relates to the Covid-19 pandemic. What makes this topic complex is that Covid-19 has precipitated an economic crisis which appears to defy the logic behind respected economic theories. For example, Keynesian depression economics recommends that in similar circumstances, governments should lower taxes and employ deficit spending to stimulate demand. However, in many emerging economies, poor tax compliance presents hurdles for efficient tax planning. For a few African countries on the verge of a loan default that may wish to employ deficit spending, the situation is like an already inebriated bus driver who wants one more glass of beer "for the road".

In addition, the aim of this essay is from the outset to provide solutions for a post-pandemic world, even though scientists have forecast the possibility of several more waves and we are becoming accustomed to new variants from mutations and vaccine supply chain inefficiencies, especially in some developing countries. Against this background, a genuinely post pandemic world may not materialise until far into the future. Because of the peculiar circumstances and timing of this economic crisis and its impact on debt finance, bespoke solutions are required to avert an impending debt crisis that is essentially fuelled by distrust.

Global Debt Outlook

The economic distress triggered by the pandemic has been escalating since the first couple of cases were diagnosed. Over the past year, the global debt to GDP ratio has ballooned by 35 percentage points to over 355 per cent of total GDP (Jones, 2021). By comparison, the 2008 and 2009 financial crises saw debt to GDP ratios increase by 10 and 15 percentage points respectively. The present 35 percentage point increase goes far above what was experienced in 2008 and 2009 (Jones, 2021) to a new

record high across all benchmarks. It has also been established that most of this increase is being pushed by government spending.

The resulting butterfly effect is easy to discern. Household debts increased as unemployment rates went up; SMEs and multinationals faced a slow-down of the entire supply chain accompanied by a drop in sales and cash which further made debt repayment difficult; and for financial institutions that had significant lending, debtors were pushed to flout credit terms and loan covenants. Various governments have intervened by injecting cash into these institutions, but the relief has sometimes been short-lived. This is due to the fact that much of the stimulus and temporary debt relief provided was diverted to repay debt obligations rather than used for investing, thereby jeopardising economic recovery.

Who Needs Help and Why?

In the African Union, there has been widespread speculation that some member states are on the verge of losing significant sovereign assets to their foreign lenders. This is a region with vast human and natural resources, including arable land that is especially sought after in developed economies. Africa has all the essential ingredients to become an economic growth powerhouse, but in what appears to be an exercise in futility.

The debt crisis that bedevils Africa was prevalent before the pandemic, with debt default and debt to GDP ratios already at alarming levels. In December 2020, out of 38 countries that were evaluated for debt sustainability , 14 were categorised as at high risk of debt distress, while 16 other countries were judged to be at moderate risk. Only two of these countries were seen to be at low risk (AFP, 2021). In a post pandemic era, low income African countries would need to cover two major gaps: the debt obligation gap and the infrastructure/poverty alleviation gap. With their current level of poverty and unemployment, many African countries are heading for a recession that they will not be able to exit.

In addition to the reasons noted above, African countries also urgently need help because most of the debt agreements and decisions among the lenders and borrowers have been known to disregard distributive and procedural justice.

Ethical Implications of Debt

Barry (2005) starts by using the concepts of morality and justice to explain the ethics of debt. For an agreement to be ethical, it has to be moral and just. According to Barry, morality is concerned with what players in a game should do, in addition to their compliance or non-compliance with the rules of the game. With regards to justice, the question is whether the players are involved in the appropriate game for them, or whether the rules should be revised.

In considering the ethical implications of debt, it is essential to evaluate whether creditors should be more or less biased towards their debtor countries and whether these debtors need to be more responsible and accountable to their lenders and their own citizens. In this context, it is right to question the legitimacy and intention of governments which bind their citizens to gruelling, long term debt obligations through irresponsible borrowing.

In addition, it has been accepted that justice is composed of two elements. Firstly, there is distributive justice, which distributes benefits and burdens fairly within a social system. Secondly, there is procedural justice, which evaluates how the fundamental limits within this social system are determined. Most disagreements that relate to sovereign debt are usually linked to these two elements (Barry, 2006).

Current problems with Africa's external debt finance system

While the scope of this paper covers all sovereign debt, it focuses on loans to African governments from international lenders where the most controversy has been generated. From 2010 to 2018, the mean public debt of sub-Saharan Africa went up by almost 50 per cent, making it the world's fastest growing debt accumulation region(Carneiro & Kouame, 2020). Recently, the author of this paper came across a Change.org petition from Ghanaian citizens to European fund managers seeking an end to granting multibillion loans to an already debt-heavy Ghana (Movement for Progress, 2021). Around the same time, a similar petition from Kenyans was circulating (Mkenya, 2021) while across the Atlantic, it was reported that the Bolivian Central Bank returned "onerous and irregular" loans worth $350 mn to the IMF (Reuters, 2021). These sentiments recall the circumstances surrounding the uprising led by Boudica in what is now modern Britain in 60 or 61 AD, where Roman financier and philosopher Seneca The Older called in the loans he had forced on the reluctant Celtic Britons. (Dio, 1925). Similar fears today are not irrational. However, they point to the possibility that citizens of these countries who protest against loans to their governments either do not understand how sovereign debt finance works or are unsatisfied with how these funds are allocated and utilised. Hence, two of the most troubling issues regarding this process concern accountability and debt transparency.

Accountability

In the first place, there are allegations and suspicions about corruption and mismanagement of borrowed funds on the part of debtors. African governments have been accused of being corrupt, with many lenders actually being complicit and willing to be bribed to alter debt covenants in these countries' favour.

Evidence from various studies support some of these allegations; Ciocchini, Durbin and Ng (2004) showed that countries which are perceived as more corrupt must pay a higher risk premium when issuing bonds. Furthermore, unreliable sovereign debt assessments by credit rating agencies (Maina, 2020) mean that many impoverished African countries are paying more money to service their debt obligations than other more developed countries, thereby prolonging the vicious and unfair cycle of debt-bondage.

Debt Transparency

There is also a general sense of a lack of transparency in relation to the volume and terms of debt. A case in point is China, a major lender to Africa and the world's largest creditor. Regarding Africa, there have been allegations of exploitative labour practices in borrower countries, a lack of debt transparency and problematic loan covenants that have employed rigid clauses and complex non-disclosure agreements (Reuters, 2021).While one has to be sensitive to anti-Chinese sentiment created by the pandemic, any discussion about Africa's debt crisis without mentioning China will not achieve the desired objective of fairness, especially as some of these controversies precede the pandemic and cannot be ignored. However, due to default risks, many analysts such as Igwe (2020) have pushed for borrower countries, rather than lenders, to be the responsible party for establishing and upholding debt transparency. It is suggested that moral hazard can thereby be ameliorated through a review of the exploitative elements in these "marital contracts", rather than an outright "divorce". (Sanusi, 2013).

Flaws in policy, planning and strategy execution

Another factor that is impeding progress significantly is poor planning and strategy execution on the part of borrowers in this region. Most of these countries already have a fiscal deficit and balance of payment problem and it has been established that their governments are going into debt for projects that have nothing to do with economic development. Debt is being used wrongly to support national currencies that should be freely floated to bolster general budgets , and subsidies that should not have been paid (Waliji, 2020). There are also cases where the timespans of infrastructure projects exceed the maturity terms of the bonds taken out to fund them (Adegoke, 2019). As a result, most of the projects which this debt is financing are not being completed in time to service the debts and therefore deliver all the projected benefits.

There is additionally an autonomy problem regarding resource allocation among the provinces of some of African Union member states. Resource-rich countries such as Nigeria and the Democratic Republic of

Congo have been criticized for being poor federalists in relation to safeguarding individual and local liberties at provincial and municipal level. (Iwerks & Toroskainen, 2017; Babalola, 2017). The provinces have insufficient autonomy to control resources and generate revenues for themselves, and remain dependent on monthly allocations from the central government. This allocation system is bound to stifle creativity and saddles the central government with sole responsibility for accountability.

Lastly, some of these planning issues stem from the wrong levers being used to push for growth. Some academics strongly believe that making big manifesto promises is unethical and potentially disastrous (McLachlan, 2017). African leaders have been notorious for making unrealistic campaign and manifesto promises which then increases the pressure on them to borrow irresponsibly in order to fulfil their pledges. For example, it is flagrantly irresponsible to promise that a currency that is valued at 250 to 1 dollar should be granted parity once a presidential candidate is elected. (Vanguard, 2015). What usually follows is that the borrowed money is used to support a national currency that should be freely floated. A strong economy makes a strong currency and not the other way round.

Striking a Pose with White Elephant Projects

Against this background, there are provincial heads of government who take on white elephant projects such as international airports (Sikhakhane, 2019) and FIFA standard football stadiums in provinces where citizens have only a few hours of power supply per day and lack access to drinking water. This raises the question of why lenders do not appear to include preventing such projects in their loan term conditions. Lack of debt transparency means one cannot know if these factors were considered in the first place. What is clear is that African leaders have an unnecessary and unsustainable predisposition to grow their economies too quickly. In corporate financial accounting, this is akin to overtrading, which unsurprisingly often leads to bankruptcy. The tendency of politicians in this region to strike a pose rather than a deal has bred unethical and unsustainable debt finance policies which continue to trigger boom-bust cycles.

Geopolitical and Economic Rivalries

Walter Rodney's *How Europe Underdeveloped Africa* offers a classic perspective on how Africa's division by colonial powers continues to have a negative effect on the continent's economy. The borders of many African countries were arbitrarily drawn with little or no regard for tribal similarities or differences, creating an addition obstacle to procedural and distributive justice (Rodney, 2018).

There exist different attitudes, belief systems and interests across various ethnic groups within countries in this region. These dissimilarities do not mean in themselves that debt financing is insufficient to fulfill the needs of these various tribes and regions. However, they engender a widespread feeling that some tribes and regions are more favoured than others when funds are being disbursed.

To put this problem in context, some regions within African countries generate revenues at a faster rate than other regions. For example, the bottom five internally generated revenue (IGR) earners in Nigeria are northern provinces, while the top five are southern based provinces (Oyekanmi, 2021). The southern region is home to the large oil and gas deposits that have sustained the country's economy since the 1970s. At the same time, the northern provinces have significant political influence due to their higher number of voters. Since Lord Frederick Lugard organised the forced marriage between Nigeria's northern and southern protectorates in 1914 (Campbell, 2018), there have been demands for distributive justice between these two regions (Adangor, 2015; Akinterinwa, 2021) – to such an extent that citizens of one region suggest that debt finance is only used to service the needs of other regions which appear not to be working hard enough to generate sufficient revenue for the whole country.

Based on the evidence, therefore, it is safe to say that sovereign debt financing in sub-Saharan Africa cannot achieve sustainability if these factors influencing distributive justice are not taken into account. However, the responsibility for maintaining distributive justice lies in the hands of both the borrowers and lenders. In sharing this responsibility with lenders, loan clauses can be efficiently mapped and utilised to take care of these issues.

To what extent should sovereign prerogatives be exercised?

Given the challenges described above, it is obvious that both procedural and distributive justice have been disregarded by both the lenders and borrowers. Barry (2005) in his review of ethical considerations relating to debt argued as follows:

"Some stakeholders in debt debate hold that procedural justice requires that the standing rules of global institutional arrangements be publicly known and subject to revision, monitoring, and reinterpretation through collective decision-making procedures, while others resist this, citing instead the importance of granting states the prerogative to pursue their own goals, most importantly the promotion of the well-being of their citizens" (P. 12).

The author of this essay supports the first position. You cannot leave everything in the hands of borrower countries or even the lenders to continue to pursue their own goals,

especially if these do not make a significant difference to citzens' lives. It must be stressed again that the aim is not to push for a "divorce" in these "marital contracts" between African countries and their external creditors; rather, it is to remove unethical and unsustainable elements from the contracts. The emphasis should be on promoting shared interests so that citizens of deserving countries begin to reap the fruits of sovereign debt finance in the post pandemic world.

Pathways

a) ***Education***

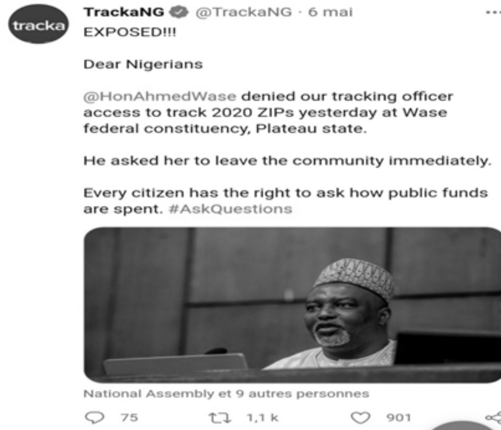
One of the reasons the Greek moral philosopher Socrates, as portrayed by Plato, hated democracy was because of his conviction that many societies would fail to meet two criteria of self-governance: wisdom and education (The School of Life, 2021). Of course, most distressed countries in the African region under consideration are "democracies", although to what extent is debatable. However, a democracy is only as strong as the amount of education which supports it. Citizens need to be sufficiently and appropriately informed so that they can choose leaders who will make the right decisions for them. Pressure groups, Western and Asian lenders, and African governments must employ all available resources to strengthen public awareness of governance as it relates to public debt utilisation, transparency and accountability. Public awareness should cover all sectors and media, to ensure that everyone is well informed, from the upper class to lower class villagers who do not have access to social media. Pressure groups, state governments and lenders must select independent representatives who will conduct surveys to test the level of public awareness before loan requests are approved. The aim is to ensure that governments whose citizens do not have at least a basic understanding of how debt finance is being used for their benefit do not receive those loans.

b) ***Watchdogs***

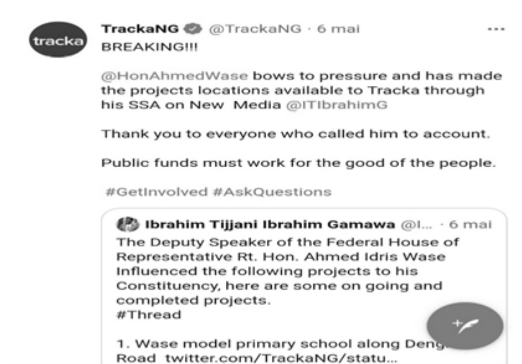
One of the hashtags that generated significant publicity in Africa at the start of the pandemic was *#followcovid19money*. Through this hashtag, the were able to engage corporations and government agencies about how they would use all funds that had been made available to countries to fight the pandemic. With a presence in countries like Cameroon, Kenya and Nigeria, the group aims to engage providers of funds and track government spending in rural communities. In partnership with this group, we have *Gambia Participates* and *Magamba Network* in Gambia and Zimbabwe respectively (Salaudeen, 2020). *Tracka*, a similar organisation based in Nigeria, has worked tirelessly to foster transparency and stem corruption in the public sector, as shown below:

In the first screenshot (Tracka NG, 2021), a *Tracka* officer was initially denied access to a

Screenshot 1:



Screenshot 2:



government capital project (*ZIP; Zonal Intervention Project*). The screenshot directly below shows the effect of an online "call out" ; access was granted to the tracking officer within 24 hours. As can be seen, sustainability is not about being "woke". It is a prerequisite for the continued existence of the human race, because there are people whose lives depend on the completion of some of these projects, most of which are funded with external debt.

While the need for watchdogs cannot be stressed enough, they must be strengthened to be truly independent. In 2019, for instance, the Nigerian co-founder of *BudgIT*- a similar civic group to *Tracka* - accepted an appointment from the nation's budget ministry. It was worrying that his subsequent resignation came only after many Nigerians criticised his decision to take up the appointment (Channels Television, 2021). Most pressure groups receive funding from bigger donor agencies such as the Bill and Melinda Gates Foundation and Oxfam. It follows that these international supporters must ensure that engagement clauses prevent the founders and managers of pressure groups from accepting contracts and political appointments from the governments that they are supposed to be monitoring. Perhaps the watchdogs need their own watchdog. Where necessary, Western and Asian creditors must also facilitate and expedite political asylum for the activists who run these organisations, who often face incessant intimidation and threats of arrest.

c) *Debt Transparency*

Borrower countries must be made to understand that debt transparency will not hurt them. On the contrary, it would be to their benefit, because creditors put a premium on interest rates when they know that a borrower is not transparent. Overall, debt

transparency will help stakeholders to have an accurate understanding of vulnerabilities and lead to more efficient comparability and market discipline.

To this end, there should be a central, real time sovereign debt data repository that is publically available and independent of the borrower government and its creditors. But first of all, non-disclosure clauses must be removed from loan agreements because why are they needed at all?

Following this initial step, each debt facility acquired by every country in the region must contain the following disclosures:

- Debt to GPD ratio, tax to GDP ratio and the borrower's credit rating
- The identity and nature of all creditors, including the proportion of all debts owed to each lender
- The range of the interest rate.
- Any allowances for debt restructuring or their absence
- The form and duration of the loan and repayment currency of the loan and all related guarantees
- Nature of the guarantor or provider of indemnity.
- The law(s) that will guide the terms of agreements and all issues that may relate to any waiver of sovereign immunity
- Loans must be tied to specific projects which are fully disclosed
- Collaterals and asset backed transactions, including terms of repossession
- Debts that are tied to derivatives and all private placements

Based on these disclosures, a ranking system can be generated which shows those countries which are most transparent. In this way, countries can actually compete with each other in international debt markets.

Transparency ultimately leads to better repayment terms which are tied to the conditions of each country and their ability to repay. This is a sustainable, win-win outcome that would help allay mistrust between the lender and the borrower, while ensuring that the citizens of these countries enjoy the full benefits of all loans negotiated on their behalf.

Infrastructure versus start-up financing

There is growing evidence that start-up financing is more effective than large and general infrastructure finance. According to McKinsey, Africa's track record in moving infrastructure projects to a close is poor. With an 80 per cent failure rate (Lakmeeharan, Manji, Nyairo & Poeltner, 2020), it is glaringly plain that loans secured to build infrastructure projects such as airports and railways have led African countries into an unsustainable debt trap (Nyabiage, 2019).

At the same time, the failure rate of African start-ups currently stands at 54 per cent, compared

with 67 per cent and 90 per cent respectively in the United States and India (Kendall, 2020). Given that African infrastructure projects and start-ups have respective success rates of 20 per cent and 46 per cent, this suggests that creditors should divert more resources into smaller, lower risk business units. This is of course a chicken or egg situation, because some experts argue that infrastructure must be on the ground for small businesses to succeed. However, studies such as Watambwa and Shilongo (2021) have shown that SME financing will significantly and positively impact GDP growth and revenue generation.

To ease geopolitical and economic rivalries, channelling debt finance into specific clusters of African economies would provide the needed distributive justice. This is mostly because different provinces and tribes have their own socio-economic strengths. In this context, the fact that some of infrastructure loans are not tied to specific projects is a major justification for more start-up financing. However, in order to solidify these gains, the ease of doing business must be facilitated in addition to the establishment of a separate start-up act in African countries. Smaller businesses create jobs, contribute to poverty alleviation and boost exports. Hence, African governments need to recognise these units as opportunities that must be protected with adequate financing and policy innovations, and not as threats that should be shut down by bureaucratic bottlenecks.

The Moment of Truth: African Countries Do Not Have a Debt Burden

Sub -Saharan Africa does not have a debt problem. What it has mostly is a revenue problem. The debt to GDP ratios of more developed economies such as Japan, Singapore, Canada and the United States are actually higher than the ratios of most African countries that are regarded as being in debt distress. A high debt to GDP ratio is largely a problem associated with developing economies (Sturgess, 2017) and there is a general consensus about the need to find innovative ways to generate revenue that will offset these deficits.

At this point, it may not be necessary to increase tax. There only needs to be efficient tax compliance, in addition to a complete restructuring of African countries' system of revenue allocation between their various states and provinces. These smaller units of government have the potential to be small but mighty, and they must be given sufficient autonomy to achieve this goal. African governments must also diversify revenue sources and reduce their dependence on mineral resources such as crude oil, which is rapidly being phased out in developed economies in favour of green energy alternatives.

After these solutions are implemented, loan clauses would come into play. Before creditors approve loans, they need to ensure that the borrower countries will

operate transparently and meet a series of requirements that are monitored by a well-informed public, including the use of innovative revenue growth initiatives, and general ease of doing business.

Some of these measures might need to be on the ground before strategies towards debt restructuring or conversion can achieve sustainable long-term success. For now, creditors, the Bretton Woods institutions, regional developmental banks, regulators and borrower countries can sometimes agree on temporary relief, restructuring, conversion or forgiveness strategies. However, the benefits from all these strategies will be short- lived if the processes for securing and distributing debt finance are not sustainable. •

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Lenders as Monitors of Risk Devolution

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Second Prize ex-aequo

Martin Lockman
United States
Attorney, Law Clerk, Federal District Court of the Eastern District of Pennsylvania, Philadelphia (United States)*

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

In March 2020, during the first wave of the COVID-19 pandemic in the United States, my fiancée worked as a trainee doctor in New York's public hospital system. When the severity of the pandemic became clear and the city began to lock down around us, we decided to isolate in our separate apartments. Our only meetings during that first month were my weekly walks across Manhattan to bring her groceries.

One grey evening in mid-April, torrential rain forced me to break from this ritual and hail a ride through an app. As I climbed into the van, the driver thanked me – although he had been driving since 6:00 a.m., I was one of the few passengers he had found. Eager, I am ashamed to say, to change the subject, I complimented him on the plastic barrier between the front and back seats that he had clearly installed himself. "Oh, I'm being very careful," he told me. "I can't afford to be sick!"

The rest of the ride passed in silence. I exited the car on 1st Avenue, next to Bellevue Hospital. Across the street, travelling nurses brought into New York City on temporary contracts to bolster the overwhelmed medical staff assembled refrigerated morgue tents in the gardens.

This essay is written in the context of the ongoing COVID-19 pandemic which has killed millions worldwide and seen the kind of widespread emergence of risk that would have been barely imaginable a few years ago. Entire industries have been suspended on a global scale, and millions of businesses have been closed by government order.

My driver, the travelling nurses and tens of millions of other workers across the world are forced to navigate the pandemic through a web of short-term contracting that presents serious ethical issues. These contingent contracts range from highly detailed and highly compensated month-long contracts for the travelling nurses to my point-and-click 10-minute contract with my driver. However, both the nurses and the driver fall outside the context of traditional employment and bear significant individual risks.

As the Observatoire de la Finance research group noted after the 2008 financial crisis, liquidity in markets can conceal the erosion of crucial but intangible social and economic infrastructure — trust, loyalty, and patience. (Observatoire de la Finance, 2008). Similarly, unfair allocations of risk can be invisible during times of prosperity. When risks materialise in a crisis, however, the ultimate bearers of those risks become apparent. This presents unique ethical issues when risk is devolved to "smallholders"; poorly-diversified individuals whose primary source of income involves leasing their labour or property either directly or through thinly-capitalised companies. The ethical issue is simple: during good times the distribution of risk can be invisible to ordinary people, and sophisticated companies can get away with shifting quite a lot of risk to smallholders. When a crisis emerges, these smallholders go bankrupt or go hungry.

This risk devolution is not inevitable, however, and finance practitioners are well-positioned to rein in some of the worst abuses. In the first part of this essay, I describe the risk-pooling function of a traditional firm and outline how this is eroded by the growing trend of smallholder risk devolution. Next, I argue that finance structures play a key role in incentivising such risk-shifting, and that debtholders are well-suited to police smallholder risk devolution because it presents structural risks to the interests of debt. Finally, I suggest mechanisms for debtholder monitoring of risk devolution.

Risk devolution in the contingent economy

The modern economy is dominated by "firms" — organisations of individuals and assets under the direction of a specific legal entity that participates in market transactions externally but allocates resources internally through command-economy structures rather than market mechanisms. In an early and highly influential account of the origin and purpose of firms, Coase theorised that firms exist because pricing discrete assets or activities can be less efficient than pricing control rights over those assets. Creating a firm through asset acquisition and employment contracts avoids costs associated with discovering prices, negotiating "complete" contracts, and forecasting future needs in the

face of uncertainty. An employer who buys an employee's labour rather than paying for discrete actions, or a company that buys a supplier's company rather than paying for discrete products, does so to avoid the cost of negotiating and pricing "complete" contracts. (Coase, 1937).

Grossman and Hart describe incomplete contracts in Coasian firms as creating two kinds of rights: "specific rights" that are allocated by the terms of the contract and "residual rights of control" — the power to fill in gaps. In an integrated firm (as opposed to a collection of contractors pricing each action), ownership of the firm is synonymous with control of the residual rights; everything that is not explicitly traded by contract. (Grossman & Hart,1986, p. 716). By buying residual control rights, firms act as employee risk-pooling mechanisms.

However, "gig economy" structures disaggregate these risk pools by leaving residual rights with gig economy contractors. This presents serious ethical issues because it erodes the coinsurance function of the firm and discretely devolves significant risk to contingent workers.

Firms as an employee risk-pooling mechanism

One often overlooked function of firms is that they provide a level of diversification to employees who sell their residual control rights to the firm. This "diversification" function is not limited to international firms or complex and internally diversified companies. At a basic level, any firm provides a hedge against uncertainty for employees. The most obvious forms of coinsurance between employees are often prescribed by law or explicitly included in employment contracts; sick leave, vacation and other flexible work structures rely on a firm's capacity to reassign employees to cover new tasks. However, even employees in jurisdictions with limited labour protections usually derive a level of immediate coinsurance through their sale of residual control rights to the firm, because collective employment can function as a macro- and microeconomic hedge. Employment at a global firm may reduce an employee's exposure to national-level economic volatility. Employment at a firm that produces multiple products can protect workers against volatility in product demand; a worker can simply be asked "to move from department Y to department X" (Coase, 1937, p.80). This hedge functions at every scale. If more grocery store customers decide to check out with Clerk A than Clerk B in a Coasian firm, Clerk B will not be paid less for that hour of work.

This hedge comes from the "incomplete" nature of traditional employment contracts, which imprecisely define a general range of duties and compensation terms. This flexibility provides a fundamental level of certainty for the employees

entering into such contracts: show up to work, perform the work that you are assigned, and receive the specified compensation. At the same time, the owners of the firm hold not just residual control rights but the accompanying residual risk, and entrepreneurs are tasked with filling in these gaps productively.

Risk in the contingent economy

The gig economy inverts the relationship between entrepreneurs and workers. Workers in the gig economy do not resemble employees in a Coasian firm because they are not subject to regular employment contracts but instead paid for discrete tasks. In such circumstances, most of the terms left unspecified by the contract are open to being "filled in" by the contingent worker. This economic arrangement is not new or historically unusual, although the rise of the platform economy makes such contingent arrangements highly visible. Pay-for-performance, also called piecework or the "putting out system", was a staple of the early industrial revolution. It is also not unique to "contractors". The Brookings Institution recently highlighted the rise of "just-in-time" scheduling practices that schedule shifts on short notice based on expected demand and devolve similar risks to employees of otherwise Coasian firms (Guyot & Reeves, 2020).

With the retention of residual rights, however, comes erosion of coinsurance. A delivery worker or cab driver working under a gig economy contract is entirely subject to the risk of fluctuations in their work. A worker who is healthy or sick, quick or slow, lucky or unlucky, is fully exposed to the variability in their output. Browning notes that many contingent workers attempt to mimic the coinsurance function of the Coasian firm by diversifying their labour: working for multiple platforms, maintaining traditional employment in addition to "gig economy" employment, or pooling resources with a spouse. (Browning, 2021, p.28). This internal diversification is very similar to the strategies employed by poor workers faced with precarious economic circumstances and a high risk of variability across the globe. However, this diversification comes with attendant costs, including a strong disincentive to specialise in the absence of a concentrated demand for that specialisation. At the same time, the entrepreneur is protected by this risk devolution. When workers are fully contingent the entrepreneurs who hire them can benefit from the same insurance mechanism that protects slow or sick workers in a Coasian firm: a "portfolio" of available contingent workers.

Ethical issues raised by risk devolution

Specific ethical issues are raised when risk is devolved to smallholders. The defining features

of a smallholder that raise ethical concerns are (1) thin capitalisation and (2) an individual reliance for daily sustenance on contracted assets (individual labour, a small plot of land, a personal car) that are difficult to employ in a diversified way. These features raise ethical concerns because they result in materialised risk either passing through to the community as an externality or being absorbed by the smallholder, who is forced to reduce his or her own consumption.

A fundamental principle of transactional ethics is that costs should not be imposed on actors who are not parties to the transaction. These externalities are both inefficient, because they incentivise transactions that are value-destroying to society as a whole but profitable for their participants, and unethical, because they unilaterally impose harm on unwilling third parties. Browning notes, however, that thinly-capitalised smallholders have few options other than to pass on harms as externalities, whether by seeking bankruptcy protection against their creditors or by relying on the social safety net. (Browning, 2021, pp. 32, 38). Entrepreneurs who devolve risk in turn derive some benefit from these externalities. An agrobusiness firm contracting with small farmers, for example, may indirectly benefit from the unpaid labour of a farmer's relatives or economic development incentives directed towards poor farmers. Sophisticated entrepreneurs drafting short-term contracts may also devolve or externalise risks that only appear over time, such as environmental risks from soil degradation or pollution.

In transactions with smallholders, even value-neutral risk-shifting presents serious ethical concerns. In the abstract, a transaction with a value of $120 (a day's work at New York City's minimum wage) has the same expected value as a transaction with an even chance of producing a return of $0 or $240. However, here finance elides the human cost of risk devolution. As Dembinski notes, "[n]umbers disguise the rough edges and gaps in reality by postulating an ideal world in which all things are perfectly divisible and perfectly interchangeable". (Dembinski, 2017, p.26). When a risk allocated to a smallholder materialies, it directly impacts their quality of life. United States Congressman Danny Davis, discussing deferred unemployment benefits, put the issue bluntly: "You can't eat retroactively." (Davis, 2020).

An observer might argue that smallholders can and do price these risks into the fees they charge for contingent employment. This explanation, however, assumes a level of sophistication and true choice between the parties. In reality, risk devolution often occurs in the context of effective monopsony or unequal access to legal systems and advice. Even if perfectly equal negotiation occurs, the "negotiated risk" theory does not explain why

a truly unanticipated risk such as COVID-19 should be allocated to smallholder contractors versus equity.

The role of debt in restraining risk devolution

Finance specialists reading this article may well ask why they should care (or more charitably, how they can help). Ultimately risk devolution is a product of a company's labour agreements and local regulation, and specific labour terms are rarely set in financing agreements. However, smallholder risk devolution has ethical implications for finance specialists because debt instruments place external pressure on managers during crises such as the COVID-19 pandemic in which devolved risks materialise. At the same time, covenants and terms of debt instruments may provide a decision-making framework that shapes even the unrelated behaviour of debtor companies in response to crises.

Equity representatives may have difficulty making credible commitments to protect the interests of smallholders when distributing risk in the face of an emerging crisis. Debtholders, however, are well-positioned to restrict risk devolution to smallholders because the interests of debtholders and contingent workers align in certain crisis situations, as debtholders have an interest in preserving the enterprise value of the distressed company (as opposed to the value of the company's equity).

Debt contracts as ethical instruments

The drafting of a debt contract represents what Dembinski describes as a key ethical "structuring moment" for the debtor (Dembinski, 2017, p.22). Debt contracts create transaction costs that limit the scope of future behaviour and reorder the existing incentives of management. At the same time, debt contracts create new rules and institutions to shape the ethical intuitions of decision-makers. As such, ethical considerations should be expressly considered during the negotiation of significant debt contracts.

Debt instruments influence the behaviour of the parties to such instruments by creating transaction-cost barriers around certain activities. Gilson famously described transactional lawyers as "transaction cost engineers" who add value to economic exchanges by reducing transaction costs through the creation of private codes of governance; that is to say, contracts (Gilson, 1984, p.253). However, contracts also *create* transaction costs as mechanisms for enforcement. The cost of breaching a condition of a debt instrument is often the acceleration of the underlying debt. Certain legal mechanisms increase this cost; for example, a collateralised lender may seize accounts, assets, or even third-party contracts to enforce its right to repayment.

These synthetic transaction costs not only limit prohibited actions but

influence second-order decisions as well. Hart and Moore (1995) note that equity holders may structure debt precisely to discipline managers of firms by requiring them to generate and disgorge short-term free cash flows. The manager of a restaurant closed by COVID-19 who must choose between paying workers or paying debt will have to consider the costs associated with default. That decision will be influenced by the structure of the debt. A manager may prioritise payments differently if the lender can enforce its claims directly by seizing the restaurant's accounts.

Finally, contractual restraints in debt instruments provide an ethical lodestone that will steer future decision-making processes. Tung (2009) demonstrates that the terms of debt instruments have a significant impact on day-to-day corporate decision-making; arguably more so than the preferences of independent boards. This may be in part because the private legal ordering created by transactional lawyers provides clear guidelines for managerial activity. Mayer notes that managers often "exist in an artifactual context" where legal standards and institutions "are sometimes *created* by common practice" (Mayer, 2001, p.217). While financial actors may sometimes intentionally breach contracts, clearly established legal duties — even unenforceable ones — can have a significant impact on moral intuitions and may make otherwise abhorrent ethical decisions seem permissible (Huang, 2017). Our hypothetical manager, now choosing whether to default on his or her advertising bill (owed to a freelance artist) or plumbing bill (owed to a large corporation), may be guided by mortgage covenants that require the ongoing maintenance of the restaurant and say nothing about advertising.

Isn't this management's problem?

At first glance, the managers of firms seem like the obvious monitors of risk devolution to smallholders. Even accepting the significance of debt as an ethical structuring tool, managers are charged with structuring smallholder contracts *and* debt contracts. However, managers are limited by the extent to which they owe legal, contractual, and cultural obligations to other constituencies - most commonly equity.

Equity representatives may genuinely want to include risk-protection mechanisms in contracts out of concern for the orderly operation of the enterprise or the ethical treatment of their counterparties. However, the interests of equity and labour dramatically diverge in a crisis such as the COVID-19 pandemic, when cash flows dry up and a manager is forced to cut costs to preserve the equity value of the company. Faced with imminent bankruptcy, formal codes of ethics and internal norms may be insufficient to persuade managers to police their own compliance with debt covenants.

Greenfield described the challenge of integrating ethical standards into well-defined corporate managerial roles when he noted that "[t]he 'role morality' of executives, created by law and norm, creates for them the overarching and urgent goal of producing financial returns for shareholders, focused in the short term. That goal subordinates other matters" (Greenfield, 2008, p.429). Even well-meaning equity representatives will struggle to effectively advocate for smallholder protections in debt instruments if such protections conflict with what many perceive as the "primary purpose of corporate governance" — profit-maximisation for equity (Henderson, 2012, p. 1414). Without fundamental changes to the systems in which managers work, ethical duties that impose costs or lengthen decision-making time horizons beyond those prioritised by equity investors will often be overpowered by cultural and legal duties owed to equity. Ultimately, as Greenfield puts it, "[w]e cannot expect people to act as Saints in a devilish system" (Greenfield, 2008, p.435).

Debt as a monitor of risk devolution

In contrast to equity holders, debtholders are well-positioned to monitor risk devolution. Debtholders (and in particular, banks) are already adept at monitoring the activities of borrowers and using sophisticated covenant structures to curb excessive risk-taking by management. Additionally, structural risks to employees and smallholders present structural risks to the interests of debtholders as well. The reason for this alignment is simple: a company's contracts are significant operating assets, and lenders have an interest in preserving those assets in crises.

As previously discussed, private lenders often have more tools at their disposal than independent directors do to exercise control over the day-to-day operations of a borrower. Bank lenders are especially adept at monitoring borrower cash flows and net worth. Similarly, lenders regularly prevent borrowers from undertaking fundamental changes to their business and have the capacity to monitor the internal governance of borrowers by requiring disclosure, mandating periodic reporting and even sitting directly on the board of the borrower entity. Ultimately, sophisticated lenders have a large suite of tools available to enforce covenants once they are in place.

Debtholders are also incentivised to monitor risk devolution to smallholders because contracts, including employment contracts and contingent worker contracts, are key operating assets. While ordinarily debtholders might welcome structures that shift risk away from the core business of the borrower towards third parties, the dynamics and analysis of smallholder risk devolution are different precisely because of the thin capitalisation that characterises smallholders.

Well-capitalised counterparties may be able to absorb or insure against shifted risks, but smallholders by their nature will be harmed — maybe irreparably — by significant materialised risks. In the same way that covenant-heavy loans often prevent borrowers from skipping maintenance on valuable real estate to save short-term cash, lenders have every incentive to ensure that unexpected volatility or risk is not shifted to smallholders in a way that damages the value of the smallholder contracts. If a lender knew *ex ante* that our hypothetical borrower's restaurant would shut down for a month due to quarantine regulations and then reopen, the lender would have every incentive to make sure that equity, not smallholders, absorbed the cost of that crisis.

Limits to lender monitoring

Despite the alignment of interests between debtholders and smallholders, there are serious limitations on lender monitoring of smallholder risk devolution that should prevent finance ethicists from viewing it as a panacea. Fundamentally, the limits of lender monitoring are set by the simple fact that debtholders' interests will not always align with smallholder interests.

Debtholder interests may diverge from smallholder interests in crises where bankruptcy is imminent or where the cost of smallholder replacement is low. While smallholder contracts are assets of the borrowing company, they are not infinitely valuable. The lender's assessment of the "restaurant lockdown" scenario described above will depend in part on the replacement cost of the smallholder contracts, and in part on whether and when the lender expects to step into the equity role. If the cost of contract maintenance is less than the cost of contract replacement, debtholders may abandon smallholders.

Debtholders may also be overly-conservative in their monitoring and reduce risk that smallholders would prefer to bear. Some contingent workers prefer the flexibility and higher per-hour salaries that they can command outside of the typical firm structure. Given the diversity of smallholders we should not be surprised to find a diversity of risk preferences. Lender-influenced governance, on the other hand, may be risk-averse to a fault (see, for example, Tung, 2009).

Finally, third-party risk devolution controls offer only limited protections for smallholders because the terms of debt contracts are simply transaction costs, not insurmountable barriers. The normal outcome of a covenant being violated is renegotiation, not acceleration and foreclosure. Ultimately, covenants just give lenders an *option* to restrain borrower activity, which is often traded for better terms (Tung 2009, pp.26-27). While the terms of the debt agreement will set an ethical baseline for discretionary decision-making, a lender may still

be "bought off" by a borrower who determines that renegotiation with the lender is cheaper than protecting smallholders.

Making lender monitoring work

Risk devolution to smallholders occurs globally, across a dazzling array of industries. The travelling nurses and the taxi driver mentioned in the introduction were each operating as contingent workers, but probably faced very different contractually devolved risks. This diversity of circumstance, and the accompanying diversity of contracts devolving such risk, means that there is no universally applicable tool that will allow lenders to appropriately restrain managers from devolving unacceptable risks to smallholders.

However, traditional covenant-heavy finance provides three clear models for monitoring risk devolution: (1) event triggers based on *force majeure* clauses; (2) volatility triggers; and (3) procedural protections against risk devolution.

Force majeure clauses

The COVID-19 pandemic, as an unanticipated catastrophe that falls outside any party's control, suggests an immediate model for lender monitoring: *force majeure*. Conceptually, *force majeure* clauses (also called "Act of God" clauses) are meant to capture large-scale "no-fault" risks such as floods, earthquakes, and wars, that prevent the terms of a specific contract from being performed. When a *force majeure* event materialises, it excuses the nonperformance of certain covenants and obligations made impossible by the event. Traditional *force majeure* clauses would need to be modified to match specific lender concerns regarding risk devolution; for example, to contain an assurance that the borrower will continue paying smallholders whose performance is barred or rendered unnecessary by a *force majeure* event. This mimics the logic described previously: that at a bare minimum the costs of truly unforeseeable risks should be borne by equity rather than undiversified smallholders.

However, the *force majeure* model has an inherent flaw: it is not very sensitive. Classic *force majeure* events are catastrophic disasters and tend to be interpreted quite strictly. Any *force majeure* trigger that limits risk devolution would have to be specifically tailored to the devolving contracts. For example, contingent workers may be equally harmed by a government-mandated business closure and a lack of customers caused by pandemic fears, but the second circumstance would not fall within most *force majeure* clauses. This lack of sensitivity would seriously limit the usefulness of *force majeure* clauses as smallholder protections, although at a minimum such clauses would protect smallholders (and their contracts) during extreme disasters.

Variance triggers

Debtholders can also use "variance triggers." Structured as contingent events of default and sometimes combined with concepts such as "material adverse effects", a variance trigger is treated as an event of default if a measured outcome changes within a certain time following a potentially material event. For example, a classic variance trigger may provide for an event of default if a borrower's credit rating drops following a significant sale of assets. This trigger would function to discourage such a borrower from making sales that could reduce its creditworthiness.

The success of a smallholder variance trigger would hinge on the specific variable tested. Too-specific variable tests may be subject to "gaming" without careful construction. For instance, if the lenders set a standard for weekly smallholder pay to protect against income variance, a borrower could maintain a high per-smallholder payment amount by changing the way it devolves risk, terminating select smallholder contracts rather than reducing overall pay. Variance triggers tied to pay would lean heavily on sophisticated lenders' ability to closely monitor and direct borrower cash flows.

Procedural protections against risk devolution

Finally, lenders may decide to take an active role in firm governance by establishing broad governance principles that restrain risk devolution. As previously discussed, the disadvantage of mandating specific terms is that it is expensive to negotiate and articulate *ex ante* rules that capture an uncertain future, and rigid yet incomplete rules are subject to manipulation. This is the underlying idea behind the Coasian firms: rather than negotiate "complete" contracts that capture all future contingencies, parties may choose to bargain for control rights over future uncertainty.

The downside of procedural risk frameworks is that hands-on approaches to governance can be expensive for lenders and may be resented by borrowers. If borrowers can find loans on the market with less-burdensome covenants, they may reject significant constraints on their managerial discretion (Tung 2009).

Conclusion

The importance of protections for contingent workers has been made evident by the COVID-19 pandemic, which has resulted in the widespread materialisation of delegated risks and caused economic catastrophe for contingent workers across the globe. Fortunately, lenders' interests align with those of smallholders in curbing the worst abuses of risk devolution: those in which unanticipated risk is allocated to smallholders rather than absorbed by equity. Lenders can offer smallholders access to a range of contractual tools from covenant-heavy financing that can be

repurposed to limit risk devolution.

There are clear limits to debtholder monitoring, and it is crucial to recognise that debtholder monitoring of smallholder risk devolution is merely a proxy for universally-applied statutory protections. However, in a time "in which culture and community are eroded by rapid economic change," practical reforms that tie the interests of lenders and smallholders together can provide a clear and achievable goal for finance ethicists (Mayer, 2001, p.219). As COVID-19 recedes and economies reopen, it is incumbent on every participant in the post-pandemic economy to learn from the failures of pre-pandemic systems. Aligning debtholders with smallholders in the post-pandemic world to rein in managerial risk devolution will build structural resiliency and strengthen our financial system against future risks that have yet to be imagined. •

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Part II

Technological Challenges and Ethics

Technomoral Financial Agents: Ethics in the Fintech Era

Ethics & Trust in Finance
Global edition 2018-2019

First Prize *ex-aequo*

Dr Marta Rocchi
Italy
Assistant Professor in Corporate Governance and Business Ethics, DCU Business School, Irish Institute of Digital Business, Dublin (Ireland)*

* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

The discussion on the future of finance, with particular reference to the fintech (financial technology) sector, is lively in academia (Bussmann, 2017; Lynn, Mooney, Rosati, & Cummins, 2019; Turner et al., 2010), among practitioners (e.g. KPMG International, 2018; PwC, 2017), and in the public arena (e.g. in Europe and in the USA, see Karakas & Stamegna, 2017; Mnuchin & Phillips, 2018; Stamegna & Karakas, 2019). It is part of the wider debate on the future of work (World Economic Forum, 2018) and the disruptive wave of the Fourth Industrial Revolution (Schwab, 2016).

The future of finance shares some of the same questions and concerns about the future of work: whether and to what extent artificial agents will be able to replace human agents in their daily jobs; how employment will be affected; what new occupations will be generated by technology, and consequently which new roles will human agents be able to perform (Bartleby, 2018; World Economic Forum, 2018). Specifically in reference to finance, this debate mainly concerns the rise of the fintech industry and the increasing automation of financial activity (Chishti & Barberis, 2016). Can financial technologies replace what traditional finance currently encompasses? Which jobs will be completely automated and which new ones will be created in the future of finance (Mancher, Huff, Grabowski, & Thomas, 2018)? How is the generation of trust affected (Greiner & Wang, 2010)? How will regulation keep up with the pace of technological change (Treleaven, 2015)?

While the debate on the future of finance is particularly abundant and animated, the same cannot be said for the debate on the future of ethics in finance. Is the ethical analysis conducted up until the advent of fintech still applicable to this new course of financial activity? Should the moral standards required of financial agents be updated in light of the changing context? Is it necessary to develop a techno-financial ethics for techno-financial agents?

The aim of this article is to look at the future of ethics in finance in order to advance a theoretical and practical proposal, guided by three questions:

1) What kind of ethical reflection is able to support the future of finance?
2) What are the virtues that financial agents need to develop, in order to be excellent financial professionals and excellent people in the fintech era?
3) How can we implement an educational strategy with which to train technomorally virtuous financial agents in the fintech era?

In order to answer these questions, the article is organised as follows. Section 1, answering the first question, shows the relevance of a first-person ethics for present and future financial activity. In response to the second question, Section 2 compares the classical virtues with the virtues required of financial agents in the fintech era. This section covers the main theoretical contribution of this article concerning the development of the technomoral virtues of financial agents. Section 3 suggests guidelines to implement curriculum changes in finance education according to the proposal advanced by this article, thereby providing an answer to the third question.

1. Aristotle and Fintech: An Agent-Centred Ethics for Finance

What sort of ethical reflection is able to support the future of finance? The word "ethics" is probably one of the most misused in different domains of human activity. Everyone speaks about "ethics" and the importance of being "ethical." However, when it comes to providing a definition, it is hard to characterise what "ethics" really is.

The philosopher Abbà offers an insightful classification of the different approaches to ethics (Abbà, 1996). He distinguishes two ways of looking at ethical enquiry: a first-person and a third-person approach to ethics. The first-person approach views ethics as the discipline that asks what is the good life for human beings, a life worth living. This approach looks at a person's actions in the context of their life understood as a narrative unity, oriented to their flourishing, to the realisation of the best version of themselves. Aristotle can be considered the father of this approach (Aristotle, 2000). Virtue ethics is the label under which this

first-person approach to ethics is generally known. On the other hand, the third-person approach views ethics as the discipline that answers questions such as: Is this action licit or illicit? Does this action comply with existing norms? Under the category of a third-person ethics, it is possible to collect deontological ethical theories (e.g. Kant), approaches typical of Utilitarianism (e.g. Bentham), and more recent theories on neo-contractualism and justice (e.g. Rawls).

Similarly to the first-person/third-person distinction, Annas (1993) suggests a distinction between agent-centred and act-centred approaches to ethics. She clearly explains how "ancient ethics centres on the notions of happiness, of virtue and of the agent's deliberation about his life as a whole" (Annas, 1993, p. 5); while modern ethical theories tend to consider "isolated problems in the abstract" (Annas, 1993, p. 124) and to view morality as "punitive or corrective" (Annas, 1993, p. 4). Ancient ethics can thus be considered "agent-centred," while modern ethical theories are "act-centred."

In the ethics of finance, the debate has mainly relied on third-person or act-centred approaches to ethics: What is it licit to do in this particular situation? Is this course of action "ethical?" Thinking about the diffusion of codes of ethics, compliance departments, and standards of practice, it is easy to retrace the origin of the ethical evaluations of financial activity in deontological and Utilitarian theories. The main textbooks on the ethics of finance also generally prioritise the description of the morality of certain acts or situations without considering the life of financial agents as a whole, or how they can grow in the virtues. The virtues of those working in finance are actually a marginal element of the majority of the most used and renowned textbooks in the field (e.g. Boatright, 2010, 2014).

The dominance of a third-person approach to the ethics of finance can be retraced in the history of philosophy. Ancient virtue theory was obscured during the history of ideas,[1] and the publication of Anscombe's essay *Modern Moral Philosophy* (Anscombe, 1958) is generally recognised as the beginning of the rediscovery of an ethics centred on the virtues of human beings, rather than merely act-centred or duty-oriented. Since then, reflection on the ethics of business – which can be considered a parallel field to the ethics of finance – also rediscovered an ethics of the first person. A recent handbook illustrates just how broad is the scope of virtue ethics in business (Sison, Beabout, & Ferrero, 2017), and the work of the Neo-Aristotelian philosopher Alasdair MacIntyre has a particular influence on teaching and research about virtue ethics in business (Beadle, 2017).

1 The analysis of the reasons why this happened would go far beyond the scope of this article. For an accurate overview, see MacIntyre, 2007 [1981].

Virtue Ethics in Fintech: Excellent Financial Agents *and* Excellent People

Although its rediscovery has happened at a slower pace than in business ethics, virtue ethics is currently a presence in academic research on the ethics of finance (e.g. Sison, Ferrero, & Guitián, 2019). Alasdair MacIntyre's critical reflections on finance have also sparked a considerable debate in this growing discussion on virtue ethics in finance (e.g. Ferrero & Sison, 2017; Robson, 2015; Rocchi, 2019; Rocchi & Thunder, 2019; West 2018; Wyma, 2015). However, too little has been done so far about shaping the education of financial professionals according to the standards of virtue.

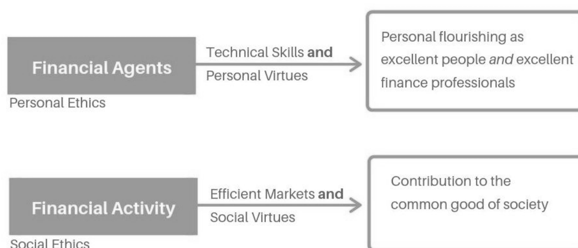
The adoption of virtue ethics in the context of financial activity holds that the analysis of a particular activity must take into account the life of the acting person (i.e. the financial agent or manager) as a narrative unity, and consider the social context in which the activity happens. On the one hand, at the level of personal ethics, a person tends to their personal development, which ultimately concerns their happiness (Annas, 1993; Aristotle, 2000; MacIntyre, 2007); and the virtues are those specific qualities of character which enable a person to flourish, the habitual dispositions with which to pursue the life worth living (Aristotle, 2000). On the other hand, virtue ethics informs reflection on life in society, considering the common good as the ultimate end of social life and as the horizon of human work (MacIntyre, 1998). Ultimately, from the perspective of virtue ethics, ethics can be defined as "a guide for human excellence" (Melé, 2009, p. 10).

Figure A synthesizes this dual tendency to personal flourishing on the level of personal ethics and to the common good on the level of social ethics.

Applying this perspective to the ethics of finance brings to the forefront the need for a characterisation of the personal virtues of those working in finance, and of the contribution of finance to the good of society.

There are academic contributions that develop both personal and social ethics in finance. A wide range of

Figure A - Virtue Ethics in Finance: Personal and Social Ends



authors have worked to demonstrate the contribution of finance to the common good of society (social ethics perspective),[2] but what has been developed less is an agent-centred personal ethics in finance, which is what this article seeks to develop further.

The next section explores what virtues are needed for an excellent practice of finance, i.e., what are those qualities of moral character which enable a person to flourish both as an excellent professional *and* an excellent person, taking into account the new technological context. The final aim of this inquiry is to demonstrate that the approach of virtue ethics provides the best groundwork for ethical reflection, not only for traditional finance, but also for the future of ethics in finance. It gives Aristotle the chance to walk the corridors of a fintech company.

2. The Technomoral Financial Agent: Human Agency and Virtues in the Fintech Era

Section 1 suggested virtue ethics as the approach *par excellence* to the ethics of finance, given that it considers the lives of financial agents in their narrative unity and the contribution of finance to the common good. This section will further the discussion by providing a solid basis for the answer to the second guiding question of this article: What are the virtues that financial agents need to develop in order to be excellent financial professionals and excellent people in the fintech era?

In *Technology and the Virtues,* Shannon Vallor argues that the classical accounts of the virtues "still have much to offer us" (Vallor, 2016, p. 119), warning at the same time that "our current patterns of thinking about ethics and the good life may well prove ineffective, deleterious, or even catastrophic if we do not adapt them to these new technosocial realities" (Vallor, 2016, p. 23). For this reason, she formulates the notion of "technomoral virtues." She does not suggest completely brand new virtues, but rather that 21st century virtues need to be cultivated "with a *new and explicit adaptation* to our emerging global technomoral environment" (Vallor, 2016, p. 119, emphasis in original).

This article will now carry out the same effort made by Vallor, with particular reference to financial agents working in the fintech era: *the technomoral financial agents.* However, before entering into the characterisation of two technomoral virtues for technomoral financial agents, it is necessary to clarify whether the impact of technology

2 For example, Schlag and Mercado discuss free markets and the creation of a culture of the common good (Schlag & Mercado, 2012); Dembinski reflects on what kind of society we desire and how finance contributes toward its shaping in the era of financialisation (Dembinski, 2009), and what the responsibilities of finance are (Dembinski, 2017); the Nobel Laureate Shiller describes finance as the "science of goal architecture" (Shiller, 2012, p. 6), and highlights the contribution of finance to the good society.

on finance will still leave space for human moral agency. Put simply, if many tasks and even decisions will be made by artificial agents, is it really possible to speak of a human responsibility in future finance? Are virtues needed in the future financial sector, or will processes and even decisions be automated?

Fintech as Context for the Technomoral Virtues: Is There Still Space for Moral Agency?

A document from the European Parliamentary Research Service broadly defines fintech: "The financial technology (fintech) sector encompasses firms that use technology-based systems either to provide innovative and cheaper financial services directly (i.e. without the involvement of banks or other intermediaries) or to make traditional financial business more efficient" (Stamegna & Karakas, 2019, p. 1). This document highlights how fintech "covers a range of services and products, such as cashless payment, peer-to-peer (P2P) lending platforms, robotic trading, robo-advice, crowdfunding, and virtual currencies" (Stamegna & Karakas, 2019, p. 1).

Arner et al. (Arner, Barberis, & Buckley, 2016) describe a topology of the fintech industry as comprising five major areas: "(1) finance and investment, (2) internal operations and risk management, (3) payments and infrastructure, (4) data security and monetization, and (5) customer interface" (Arner et al., 2016, p. 1291). The following Table A offers a description of each of these areas.

Table A: Topology of Fintech

Topology of Fintech*	Description**
1. Finance and Investment	Alternative financing mechanisms (e.g. crowdfunding and peer-to-peer lending); the financing of technology itself; robo-advisory services.
2. Internal Operations and Risk Management	Mainly related to compliance systems, and the automation of internal processes. RegTech, as the management of the application of financial regulations through technology, is part of this area.
3. Payments and Infrastructure	Internet and mobile communications payments; financial trading; disintermediation.
4. Data Security and Monetisation	Sensitivity of collected financial data; monetary value of data collected; vulnerability to cyberattacks.
5. Customer Interface	User experience for online and mobile financial services.

** From Arner et al. (2016, p. 1291). ** For a more detailed account, see Arner et al. (2016) and Karakas & Stamegna (2017).*

With the advent of fintech, it seems that a wide range of activities usually performed by human agents have been taken over by artificial agents or automated processes across these five major areas. Would it then be useful to consider the virtues of those working in the fintech sector, or would all their personal responsibilities be delegated to artificial agents?

The fintech sector shares many of the ethical issues classically analysed in the relationship between ethics and technology. Franssen et al. report four recurrent themes in the ethics of technology: neutrality versus moral agency, responsibility, design, and technological risk (Franssen, Lokhorst, & van de Poel, 2018). Translating these issues into the language of fintech raises questions such as the following: Would artificial financial agents have responsibility for a mistake or illegal or unethical behaviour? Who should be considered accountable for the actions of the artificial agents? The debate on the neutrality of technology includes those who believe that technology has no moral content, but that its use has moral significance; others who argue that the design of technology has a moral content in itself; and others who state that both the way we design technology and the way we use it carry moral significance. Sheila Jasanoff (2016) in *The Ethics of Invention* gives voice to this debate, arguing that the way technology is designed bears moral significance, insofar as it contributes toward shaping the society we desire. The discourse can be translated to finance: the design of the innovation of fintech not only advances the technical side of the financial sector, but also shapes the contribution of finance to the society of the future.

With regard to responsibility in finance, as in other sectors, technology also amplifies the so-called "problem of many hands" (van de Poel, Royakkers, & Zwart, 2015). In this instance, it is useful to look at the distinction drawn by Mancher et al. (2018) between unattended and attended bots in finance. According to these authors, unattended bots can perform "period-end close, reconciliation, maintain master data, cost accruals, travel accruals, labor accruals, daily report generation and compilation, PP&E activities (valuation, inventory, accountability)" (Mancher et al., 2018, p. 37); while attended bots can look after more complex activities such as funds distribution and control or cost and obligation transfers, and many others, which *need to be triggered by a human worker*.

This is the reason why it is still important to speak of the virtues of the financial agent: even in a scenario where automation and artificial agents will take over many tasks, these tasks must not only be performed, but also set and assigned. While repetitive and process-based activities can be replaced, therefore avoiding many common human errors (for example, robots do not seem to have the "problem of the fat

finger," and do not have issues with memory and data storage), the same cannot be argued for other actions that human agents will need to learn in order to be able to perform. In this context of a revised human agency in the future of finance, it makes sense to take a closer look at two virtues.

Technomoral Wisdom in the Fintech Era

Practical wisdom (PW) can be described as the virtue that enables the agent to identify what is good, and to choose the best means to achieve it (Aristotle, 2000). This virtue has been widely studied in relation to management, as a large body of literature witnesses (e.g.: Bachmann, Habisch, & Dierksmeier, 2018; Beabout, 2012; Melé, 2010; Moberg, 2007). It is less studied in finance, even if it is particularly relevant for the numerous different decisions that different agents in the financial environment need to make. Schwartz (2011) argues that rules and incentives do not help people desire to do the right thing and choose the best means to achieve it; it is rather the cultivation of PW that helps people decide for the good in every situation.

Vallor rereads the definition of PW in the context of technological innovations. She argues that technomoral wisdom is "a *general condition* of well-cultivated and integrated moral expertise that expresses successfully – and in an intelligent, informed, and authentic way – each of the other virtues of character that we, individually and collectively, need in order to live well with emerging technologies" (Vallor, 2016, p. 154, emphasis in original).

Even if Vallor describes technomoral wisdom as a "general condition," it is also fruitful to explore a detailed account of the parts of PW as described, for example, by Aquinas (1964). He identifies eight integral elements essentially linked to the exercise of PW: memory, reason, understanding, docility, shrewdness, foresight, circumspection, and caution (Aquinas, S. Th. II-II, q. 49). According to Aquinas, memory relates to the knowledge of the past; understanding, to the knowledge of the present; reason refers to ways of using knowledge, combining sources and evaluating alternatives; docility helps in acquiring knowledge through the experience or the knowledge of others; shrewdness is the capacity to acquire knowledge through one's own personal research; foresight helps balance the means that the person has in the present with the purpose set for the future; circumspection helps take into account the relevant circumstances of the decision; caution helps one to avoid obstacles.

The following Table B shows how techno-moral wisdom can act along the five areas of fintech previously sketched, taking into consideration the Aristotelian definition of practical wisdom (Aristotle, 2000), the techno-updated one by Vallor (2016), and the detailed description by Aquinas (1964).

Table B: Technomoral Wisdom in Fintech

Topology of Fintech*	Technomoral Wisdom
Finance and Investment	Technomoral financial agents need to exercise foresight, circumspection and caution in deciding the best investment choice possible, not just the most efficient. Even if the processes are automated, the decisions about how to utilise them still require human wisdom. For example, a robot can detect an advantageous investment opportunity in buying shares in a company selling non-renewable energy. A human agent can mediate the efficiency of the choice by examining the historical and geographical context. Regardless of whether the choice is profitable, the question arises of whether one should support a company that helps enhance the future of humanity or one that makes a profit by taking advantage of environmental vulnerability. From the technomoral user's perspective, memory is greatly reinforced by automation, with the presence of reviews of the users of the platforms, availability of records of every transaction and project supported, amount of money spent, etc. The technomoral user's docility and shrewdness are greatly reinforced by bots and other available technical instruments that gather knowledge, while the way of using the knowledge (reason) remains human, or at least subject to human control.
Internal Operations and Risk Management	This might be the area in which human skills are more replaceable. Indeed, the automation of processes simply deducts from human agency some areas of interaction and automates efficient workflow and relationships. The reign of technomoral wisdom in this area is the wisdom of managers. Indeed, the automation impacts on how processes are developed, but cannot determine the "why." One of the strongest criticisms of managers in the postmodern era concerns exactly this point (MacIntyre, 2007; Mangham, 1995): a manager is a mere executor unless he or she is able to direct, define, and set the objectives of the firm. Technomoral wisdom is exercised in the definition of the good purpose that is achieved by the activity of the financial company operating in the fintech era. Technology is an element of the choice regarding which are the best means to achieve this purpose.

Payments and Infrastructure	The fact that payments are easier to perform does not necessarily mean that the decision about payments is easier to make. However, there are studies on the impact of contactless technology on spending behaviours: if we do not see the money we use, it seems that we are inclined to spend more (Trütsch, 2014). This is where technomoral wisdom comes heavily into play. While automation takes care of the means of payment, practical wisdom helps in discerning the best purchasing option and, thanks to techno-foresight, balances present possibilities and real future needs.
Data Security and Monetisation	Technomoral wisdom helps in assessing the value of data and in choosing its best use. Any company can own data, but not every company would make the best use of it. This area, especially in Europe – given the detailed regulation under GDPR (European Commission, 2018) – lies at the border between ethical reflection and regulation.
Customer Interface	Technomorally wise developers of technological systems devoted to financial services will strive to provide the best platform for the clients, i.e. a platform which clearly helps the final user to find information without hiding potential risks and terms of use. The choice of the best means to achieve a good end is an essential part of the definition of technomoral wisdom.

* *According to Arner et al. (2016, p. 1291).*

This overview is illustrative but by no means exhaustive. The level of detail involved in each of the aspects of practical wisdom, updated for the digital context, reveals not only the complexity of this virtue, but also the complexity of the fintech environment in which this virtue needs to be exercised. The dawn of fintech brings an opportunity to redefine the specificity of human intervention in critical decisions (e.g. *The Renaissance of Practical Wisdom* in risk management, Hoffmann, 2017, ch. 10), and gives birth to a new educational need: training technomorally wise financial agents.

Digital Integrity

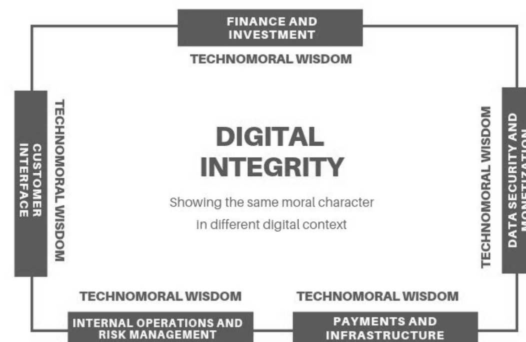
"Integrity" is another buzzword often used in the domain of finance. According to MacIntyre, "To have integrity is to refuse to be, to have educated oneself so that one is no longer able to be, one kind of person in one social context, while quite another in other contexts" (MacIntyre, 2006, p. 192). Integrity is the habitual disposition to show the same moral character in different situations. In finance, living according to the standard of integrity means,

for example, treating other people's money as if it is yours, or applying the same moral judgment to a situation in which others are involved as if you were the protagonist of this situation. Living with integrity in finance means showing the same moral character when with colleagues, clients, or at home. The opposite of integrity is compartmentalisation (MacIntyre, 2006), which means to show a different moral character depending on the situation in which a person finds themselves.

The advent of fintech calls for an update of this virtue, which has been widely studied in finance (Boatright, 2011; Cowton, 2002; Erhard & Jensen, 2012; Spitzeck, Pirson, & Dierksmeier, 2012) and now needs to be considered in the digital context. This virtue is going to be named "digital integrity," which can be defined as the "habitual disposition to show the same moral character in different digital contexts." Different authors have worked on identity in digital contexts, discovering that the exposure to different digital platforms can give rise to the existence of different digital identities for the same person. For example, Sherry Turkle, in her book *Life on the Screen: Identity in the Age of the Internet* refers to decentred and multiple identities (Turkle, 1997), while Walker warns about the fact that "the Internet self is postmodern, transitory, deceptive, and fragmented" (Walker, 2000, p. 99).

Digital integrity is needed in a transversal way in all of the five areas encompassed by fintech and where technomoral wisdom enables the agent in multifaceted aspects: it is the coherent exercise of the traits of technomoral wisdom across any activity in the future of finance. In this specific characterisation, digital integrity does not concern the markets, but each human agent operating in the fintech environment. Figure B illustrates this dynamic interaction.

Figure B - Digital Integrity in Fintech



3. Fintech and the Virtues: A Proposal for Technomoral Education in Finance

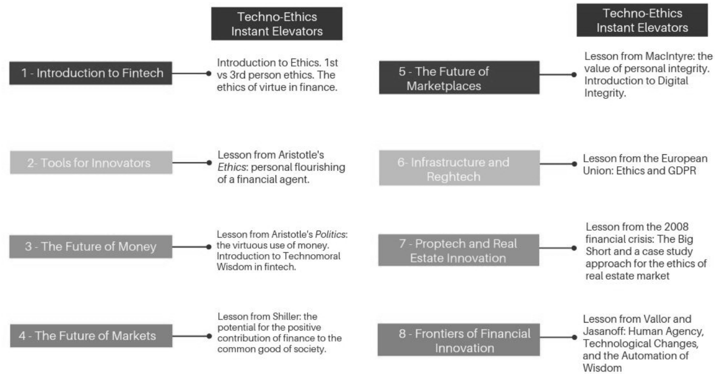
While many universities already offer specialised degrees in fintech, not all of them integrate ethics into their curricula. Some academic contributions deal with ethics in fintech (e.g. Scott, 2018; Trieu, 2016), but research and teaching in the ethics of fintech have not yet been systematically developed. At the same time, the integration of ethics into business school degrees is highly valued by those bodies assessing the value of business schools' curricula (e.g. Ethics Education Task Force to AACSB International's Board of Directors, 2004).

Integrating ethics in the newly-designed fintech curricula would save the finance of the future one of the criticisms against business education in the aftermath of the financial crisis: "Most of the people at the heart of the crisis […] had MBAs after their name ... In recent years about 40% of the graduates of America's best business schools ended up on Wall Street, where they assiduously applied the techniques that they had spent a small fortune learning. You cannot both claim that your mission is 'to educate leaders who make a difference in the world'... and then wash your hands of your alumni when the difference they make is malign" (Schumpeter, 2009). According to Dobson (2008), it is possible to integrate ethics into finance curricula at different levels, and Dembinski (2017) also suggests that the method of teaching finance itself can be different, enlarging the reductionist concept of human beings upon which the theory of financial markets is based.

In order to train technomoral financial agents, *Techno-ethics Instant Elevators* (TIEs) can be introduced across the fintech curriculum. In order to have a concrete visualisation of how a fintech curriculum can be impacted by these "TIE breaks", the following Figure C replicates the fintech online 8-module curriculum offered by Oxford University, as found in the publicly accessible sections of their website (https://www.sbs.ox.ac.uk/programmes/oxford-fintech-programme), and integrates each module with a TIE. A TIE is designed to be a learning fast track taught with solid theoretical contents, brief and informative readings, and technology-friendly design. Each TIE involves one hour of online engagement. Each hour is divided into four 15-minute learning steps: a 15-minute introduction to the topic; a 15-minute interaction with the instructor and the other learners; 15 minutes to explore the resources (readings and videos); and 15 minutes to write two paragraphs on how to face a situation related to the topic, to solve a case study, or to perform a related activity. Figure C shows the integration of TIEs in the abovementioned fintech curriculum.

All the topics and related bibliography for Modules 1-5 and 8 have been sketched throughout this article, while Module 6 on regulation

Figure C- Techno-Ethics Instant Elevators Across the Fintech Curriculum



would be best left to an expert on GDPR. Module 7 uses the movie The *Big Short* (McKay, 2015) to provide a basis for discussion on the future of real estate and fintech.

A more advanced integration of the future of ethics in finance education would consist of adding an entire module on techno-ethics, which can be introduced by reading MacIntyre's provocative article on the character of financial agents, *The Irrelevance of Ethics* (MacIntyre, 2015). Learners are engaged in a structured discussion about whether MacIntyre's criticisms of the behaviour of financial agents and financial markets as a school of anti-virtuous behaviour could change positively or negatively in the fintech era.

Conclusions

This article considers the future of the ethics of finance in the fintech era. It answers the three questions proposed in the Introduction, arguing that:

1) Virtue ethics is the approach *par excellence* to look at future financial activity in its technical and moral complexity, considering both the life of financial agents in its narrative unity and the positive contribution of financial activity to the good of society.

2) The advent of fintech leaves space for human moral agency, and financial agents involved in this industry need to develop technomoral virtues (Vallor, 2016) in order to develop themselves as excellent financial professionals and excellent people. In particular, technomoral financial agents need to develop technomoral wisdom across the five areas of fintech defined by Arner et al. (2016), and to constantly

practise digital integrity.

3) A proposal for the integration of ethics into existing and future fintech curricula has been discussed: in particular, examples of TIEs (Techno-ethics Instant Elevators) are designed to offer an effective learning opportunity that transforms the way financial agents reflect on the morality of their profession in the future of finance.

If fintech were the context which finance professionals can become the best version of themselves while contributing to the common good of society, finance would finally recover its original social function of bridging savers and investors in order to realise worthwhile projects for the common good. •

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Finance Needs ‘Bilinguals’ Too

Andrea Roncella
Italy
PhD Student, School of Economics and Business, University of Navarra, Pamplona (Spain)*

Luca Roncella
Italy
Associate Researcher at Boston Consulting Group, Madrid (Spain)*

* The views expressed herein are those of the authors and do not necessarily reflect those of the Organization they are affiliated with or of the Jury.

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“It is, in fact, arguable that economics has had two rather different origins, both related to politics, but related in rather different ways, concerned respectively with ‘ethics’, on the one hand, and with what may be called ‘engineering’, on the other.”

Sen (1988, p.2),

In celebrating the inauguration of the Schwarzman College of Computing, MIT’s new artificial intelligence hub, Rafael Raif, the president of the prestigious university, claimed the world needs *bilinguals*: engineers with better education in the liberal arts, able to build ethical products and platforms and who know how to interact with civil leaders and policy makers in order to develop responsible innovations. For this reason, MIT set up an interdisciplinary faculty that researches and teaches disciplines ranging from STEM (science, technology, engineering and mathematics) subjects to social sciences and humanities (Hao, 2019). This is an example of a concrete response to the modern problem of reductionist knowledge which sees the need for specialisation taking the form of solving complex problems through a single, and usually technical, lens.

A similar concern which to date is unresolved characterises the financial innovation process. In the aftermath of the great crisis of 2008 and the subsequent economic recession and suffering that it caused (Better Markets, 2015), there have been at least two positive consequences. The first is defined as institutional and concerns the regulatory side, which over the last 10 years has been strengthened

with measures that have made the financial system as a whole more stable, and specifically, the banking sector. The second one is concerned with cultural aspects, which is the central theme of this article and is largely about various reflections on the relationship between ethics and finance that followed that terrible September of 2008.

This "ethical" wave has seemingly spared no sector related to finance. Many, including academics and practitioners alike, have raised their voices to highlight the need to deepen the ethical dimension of economics and finance as a safeguard against similar errors in the future. In this respect, a special effort has been made to include the teaching of ethics, which has seen "business ethics" courses added to the curricula of schools of economics, finance and management. Moreover, some of the most reliable finance professional associations such as the CFA have incorporated ethics and social responsibility into their programmes.

A Gap in Finance Ethics Education

These initiatives are definitely worthy of praise. However, this article asks whether the current debate about ethics and finance might be informed by a key point. The evolution of our economic system towards what is defined as *financial capitalism* has been and continues to be conveyed mostly by unprecedented technological advances in terms of speed and pervasive capacity. Consider, for example, the rapid spread of algorithmic trading, cryptocurrencies and structured finance, and it is evident that the world of financial innovation is largely underpinned by technological innovation. Financial institutions have adapted quickly to this environment, setting up entire units of *quants* and financial engineers[1], with the aim of designing innovative products suited to their clients' most demanding expectations. The purely computational and quantitative skills that these product development roles require means that the personnel selection process increasingly draws from the exact sciences, which in turn has seen universities create a proliferation of masters degrees in financial engineering and quantitative finance. Furthermore, *ad hoc* certifications have been designed and accredited, such as the Certificate in Quantitative Finance (CQF), as proof of quantitative and mathematical skills, a key requirement for these new positions.

While technical knowledge is absolutely central to the educational process of those who fill these roles, our research indicates that ethics

1 In this article we use the two terms analogously. In particular, *quants* - as those involved in investment strategies - can be categorised as financial engineers who are more concerned in structuring financial products, if we consider the investment strategy as a kind of financial product.

education or a similar subject that might emphasise the financial sector's social responsibilities, remains absent. We argue that this is a cause for concern. Even though at first glance it might seem that the task of financial engineers is purely technical, and that it requires only mathematical knowledge, this article highlights the need for a kind of education that takes into account a humanistic component in order to integrate the non-quantitative dimensions of finance, its products and its institutions. The overarching aim is to prevent financial engineers from acquiring a purely radical and abstract knowledge that would distance them from the potential societal consequences of their work.

The article is structured as follows. The first part uses a "life history" methodology to reconstruct a typical narrative path of a financial engineer or quant. This narrative is based on our own research, with the results shown in the Annexe, which confirms the educational biases of this kind of profile while highlighting both the limits of the current financial innovation network as well as the university's role in defining these limits. The second section focuses on the reasons why the role of the financial engineer is not just a technical one. The third section focuses on the critical issues related to the current educative process of a financial engineer. Lastly, we conclude with some proposals to improve the current situation.

A Financial Engineer's Narrative

We start by analysing the educational route of a hypothetical financial engineer and show without oversimplifying, the most salient characteristics of such a profile. We also draw upon real narratives collected by Patterson (2010) and Lindsey & Schachter (2007). In order to illustrate better the specificity of a financial engineer's education, we compare it with that of a financial advisor[2], as an example of a task that corresponds with the sell-side of a product. Although a financial advisor's role is considered to be central in the financial sector, the greater complexity of financial products means that banks and investment funds have increased the number of *quants* and technicians they employ to address the technological challenges that they face and to gain a competitive advantage.

The stories collected clearly show the decided tendency towards a quantitative education of those who occupy these positions. An exemplary case is that of Edward Thorp, who is considered to be one of the *quants*' founding fathers. Thorp has a PhD in physics from

2 We use the term 'financial advisor' throughout the paper to refer to investment professionals who are registered with FINRA in the US. We do not claim that financial advisors are devoid of misconduct, even though this paper compares *quants*' lack of ethical education with financial advisors. (Egan et al., 2019).

UCLA, is a professor at MIT and an expert in creating strategies to beat the casino at blackjack and the market on Wall Street (Patterson, 2010, p. 14). He was probably one of the most important *quants* during the 1970s and 1980s. His Princeton Newport Partners Fund, set up in 1969, is recognised as the first *quant* hedge fund. During a period of 18 years it turned $1.4 million into $273 million compounding at more than double the rate of the S&P 500 and did not suffer any losses during any quarter. (Authers,2017). His book *Beat the Market* is among the bestsellers for would-be *quants*. Through his ideas, Thorp inspired young talents and directed them toward a career in finance. Among these are Ken Griffin, founder of the financial giant Citadel, and Bill Gross, father of the investment fund PIMCO; both of them heeded Thorp's recommendations to launch their respective careers.

There are also several cases of investors who followed in Thorp's footsteps, leaving the world of physics and venturing into finance. One of them is Ronald N. Kahn, who has a PhD in physics from Harvard and who is the current Global Head of Scientific Equity Research at BlackRock. He famously started his career in the financial sector without even knowing the difference between a "share" and a "bond" (Lindey & Schachter, 2007, p. 32).

These stories, while exceptional, offer an insight into what constitutes a successful profile in the era of technological finance, and at the same time confirm that the financial sector has attracted talents that might otherwise have enriched fields such as physics and engineering.

Business Schools in the Age of Financial Engineering

Even more rigorous statistics[3] suggest that an increasing number of students with technical backgrounds are turning their attention to professional careers in finance, making the transition to the financial world by an academic route such as a master degree in financial engineering.[4] The rankings offered by two of the main industry forums, QuantNet and Rank.net, allow us to observe the curricula that some of the best universities in financial engineering offer. As shown in Table 1 in the Annexe, all these masters degrees are highly specialised and apply mathematical and physical science models to disciplines such as financial risk management, financial model planning and derivatives structuring. Conspicuously, only Imperial College (UK) and

3 A report by the Institute of Physics (2012, p. 12) states: "Respondents in employment one year after graduation in Physics were working in a wide range of employment sectors with the largest numbers choosing jobs in education, finance or scientific and technical industries".

4 An example is provided by the Master of Financial Engineering Program at Berkeley University which reports that 39% of students have a background in mathematics/statistics and 27% in engineering. Only 16% have a background in economics/finance (https://mfe.haas.berkeley.edu/admissions/class-profile)

MIT (US) offer a business ethics course. In contrast, a typical MBA programne, as a path to becoming a financial advisor[5], is organised more holistically. Table 2 in the Annexe shows how business ethics courses are in fact present and considered central to the training of good professionals. All the MBAs covered by the research offer a course in business ethics, of which 75% are "mandatory".

This empirical evidence is also reinforced by the importance that a prestigious finance association such as the Chartered Financial Analyst Institute (CFA) upholds ethical and professional standards through their investment analysis and portfolio management certification programmes. Candidates are required to meet three levels to obtain the CFA. The first is focused on the ethical behaviour and the standards of conduct of a financial manager. In an attempt to match the CFA, the *quants* sector is also developing its own certification. One example is the Certificate in Quantitative Finance (CQF) which unlike the equivalent CFA, does not have any ethical references[6]. Established by the *quant* guru Paul Wilmott, the CQF aims to certify a candidate's knowledge of quantitative finance models such as Black-Scholes Theory and Credit Risk models; their knowledge of financial markets, including equities, fixed income and currency markets; and their knowledge of data science.

The difference between these two spheres of finance confirms what is claimed by West (2012, p.26): "Financiers and traders are subject to ethics oversight and professional codes of conduct; the quants are left to operate in a relative ethics vacuum". However, events where financial technology played a key role such as Black Monday in 1987, the collapse of the hedge fund Long-Term Capital Management, and the Flash Crash of May 6, 2010, have highlighted that the lack of ethics in quantitative models and strategies cannot be justified, since the majority of risk models and the complex derivatives that *quants* create for customers, are not easily understood by front-office managers. Paul Wilmott warns about the limitations of the creators of certain financial products:

"Many of the people who produce mathematical models and write books know nothing about finance. You can see this in the abstractness of their writing and their voices when they lecture. Sometimes they are incapable of understanding the markets, mathematicians are not exactly famous for their interpersonal skills. And understanding human nature is very important in this business. It is not enough to say 'all these interacting humans lead to Brownian Motion and efficient

5 As shown in Table 2, the financial sector, along with consulting ,are the industries with the greatest work demand after an MBA. About a quarter of the best MBA students in the world end up working in this area.

6 See https://www.cqf.com/

markets'. Baloney. Sometimes they don't want to understand the markets, somehow they believe that pure mathematics for its own sake is better than mathematics that can actually be used. Sometimes they don't know they don't understand" (Wilmott, 2019).

A Goldman Sachs' Story

Despite these warnings and as a result of the widespread use of these models, prominent roles in financial institutions are increasingly occupied by purely quantitative types. An illustrative example is Martin Chavez, the former head of Goldman Sachs' Strats section (the R&D division in charge of creating customised financial products) and recently appointed Global Head of the Securities Division. Chavez's personal history is emblematic of the new Wall Street leaders. He has a PhD in Medical Information Sciences from Stanford University and a masters in Computer Science from Harvard, and began his professional career by founding an energy software company. He then entered the financial sector, and specifically the Currency and Commodities division of Goldman Sachs. In 1997 he was hired by Credit Suisse as Global Head of the Energy derivatives division. In 2000 he founded Kiodex, a trading software company where he was CEO until 2004, when he returned to Goldman Sachs. He has since held a series of global positions at Goldman Sachs, including Head of the Strats section, Chief Information Officer, Chief Financial Officer, and finally his current position of Global Head of Securities Division.[7] This is just a more recent example of how to ascend to the highest ranks of one of the most important Wall Street investment banks without receiving any formal training in finance, let alone in business ethics. Yet his knowledge of computer science and his ability to solve quantitative problems has allowed him to achieve significant success in the era of quantitative finance.

As the data collected shows *quants* often do not have the opportunity during their university years to deal with issues related to the humanistic and social dimensions of economics and finance in order to gain a more integral perspective of their work. It is likely that a financial engineering graduate would not have a background in finance or business, but would have come from the fields of physics, mathematics or computer science, and would then learn how to apply the techniques studied during the undergraduate degree to the financial sector.[8]

Quants and financial advisors are two key roles in a properly functioning financial institution. Despite their distinct competences,

7 Goldman Sachs: https://www.goldmansachs.com/our-firm/leadership/management-committee/r-martin-chavez.html

8 See the requirements of the University of Chicago http://finmath.uchicago.edu/page/admission-requirements , and the University of California, Berkeley https://mfe.haas.berkeley.edu/admissions/requirements

both discharge important responsibilities. There are several routes one can take in managerial finance, including the CFA and an MBA, to learn about the human dimension of finance. This article argues that even the quantitative sector has to take into account what it contributes to the good of society. But why is such a claim relevant?

The Separation Thesis

In an essay published in 1959, the writer and scientist C. P. Snow used the University of Cambridge as an example to argue that Western intellectual life can be divided into two contrasting groups. On the one hand there are the "scientists", exemplified in particular by the physicists, while on the other, there are the *literati*, who define themselves as the "intellectuals". Between these two poles there lies an abyss of mutual incomprehension which sometimes is characterised by hostility and contempt. It is this polarisation which according to the author causes untold harm to both groups as well as to society in general (Snow, 1959/2012).

This divide that Snow portrays between the worlds of the humanities and science has gradually spread to individual disciplines, and is clearly manifested in the case of economics. Originally a branch of moral philosophy, a process of ongoing specialisation has seen economics transformed from "political economy" to an increasingly "mathematical economy", giving rise to a new subject in the 1980s involving a fusion of statistics, mathematics and economics, and which later became known as finance (Fox & Sklar, 2009). Since quantitative analysis took root, finance has became even more intertwined with pure engineering models, fulfilling part of Amartya Sen's epigraph which we quoted at the start of the article.

Even tough this evolution occurred primarily in academia, it soon found its way into the world of practitioners. Wall Street, once a kingdom of brokers and analysts who could read not only economic processes but also more human nuances of the markets (Abolafia, 2001), is nowadays the realm of *quants*, where the technical-engineering element is seen as fundamental, having displaced the more humanistic element, which is perhaps less apt at offering instant solutions. This is in line with what Whately defined as the *non-overlapping magisteria* (*NOMA*): the principle that the economy, and hence finance, is a *free-value* subject (Whately, 1831, p. 45). Even though finance fits the definition of an exact science, this article is based on the thesis that no technical analysis should be devoid of ethical considerations.

If Financial Engineers were just like Nuclear Physicists

An anecdotal analogy, concerning the great Russian physicist: Andrej D. Sacharov, supports our

suggestion. In his book *My Country and the World* (Sacharov, 1975), the future Nobel Peace Prize winner recounted how in November 1955 he had started to participate in some groundbreaking experiments on thermonuclear weapons. On a specific occasion these led to two tragic events: the death of a young soldier and a two-year old child. The evening after the experiment, during a small banquet, Sacharov - plagued by the images of the day before - expressed the hope that Russian weapons would never explode on cities. The high official who ran the experiments replied that the task of the scientists was to improve the weapons; how they would be used was not their concern. Intellect alone was not qualified to deal with it.

Sacharov illustrated through this episode how no one can evade his or her share of the responsibility for actions on which the existence of humanity depends. Faced with the official's denial of the existence of morality as a category in itself and insistence that there was only specialised scientific, political or military expertise, Sacharov argued that it was not possible to deny the existence of a common humanity, defined by some as conscience, that allows one to acknowledge that what concerns human beings takes precedence over any specialisation.

The history of Sacharov and the official underlines the moral responsibility that financial engineers also bear. The leading investor Warren Buffet has reflected metaphorically that certain financial products have the potential to be turned into weapons of mass destruction[9]. It does not therefore seem out of place to imagine the military personnel in our anecdote as a financial advisor ready to launch a market security product which might be as noxious as a *time bomb* designed by a nuclear physicist. In this context, the relevance of having *quants* with a moral awareness of their role is shown in all its urgency, alongside the concern that few people in academia are confronting this issue.

Reification and Practical Wisdom

We refer here to two major contributions regarding the ethical education of financial engineers: Rooney (2013) and West (2012). Rooney focuses on the composition and structures of the networks at the centre of financial innovation and emphasises the danger that a kind of abstract knowledge, typical of these processes, easily turn into *reification*. This concept is derived from Marxist philosophy and considers abstract knowledge as if it were true and concrete (Marx referred to the fetishism of commodities), eventually becoming more real than reality. Reification

9 In his 2002 letter to shareholders (p.15) derivatives are defined as "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal". http://www.berkshirehathaway.com/letters/2002pdf.pdf Accessed March 2019.

means that the facts – the real world - are secondary to theory and that if there is a discrepancy between theory and reality, it is reality that should step aside.

According to Rooney (2013, p. 452), the risk of reification is particularly vivid in the networks underlying the creation of financial products - see Willmott's quote above - since these networks are generally shaped to generate private positive consequences rather than public benefits. At the root of this issue is the fact that the innovation processes are marked, on one side, by a lack of openness, which implies that they usually happen within the research units at private financial institutions while universities and research centers are oblivious to them; and on the other, by the homogeneity of the actors involved. Conversely, the university – hopefully free from that short-term focus that characterises business and able to focus on larger and more complex problems - could be the ideal place for critical thinkers to develop good financial technology and understand its implications beyond mere financial objectives.

Rooney's proposal hinges on the need to rediscover the practical wisdom component within the technical processes. According to Aristotle, practical wisdom (*phronesis* or prudence) is the virtue of choosing the suitable means to the right ends (Aristotle, 1985, 1144a) and it refers to the right action in the moral things (to doing things). It implies an ethical approach, also defined as "first person account" (Abbà, 1996), according to which an action will be right if a virtuous agent would characteristically do it under similar circumstances. By contrast, our claim is that financial engineering education is exclusively focused on the "productive skill" (to make things), defined by Aristotle as *techne* (1985, 1140), and its criteria of success are as neutral as the standards utilised in the exact sciences.

Rooney's words echo West's call for a "common sense" approach rather than a blind trust in mathematical models when designing new products (West, 2012). West points out that financial engineers are not exempt from the fiduciary duty and the responsibility to match the complexity of a product with the level of clients' sophistication; nor from considering the implications of limited engineering models. In this context, he proposes intervening in the education of a financial engineer by identifying those moments in the decision-making process where ethical issues can emerge (West, 2012, p. 35).

Virtue Ethics in Financial Engineering

Both authors focus on the supposed role that the university should play in creating more integral financial innovations. At the same time, this proposal clashes with the financial engineering university curriculum, characterised by an evident reductionism as described

previously. To solve this puzzle we found a useful contribution in Han (2015), which is relevant to understanding *how* ethics can effectively have a meaning in a quantitative curriculum beyond the fact of introducing specific humanistic classes.

Han's proposal is the result of an original mixture of virtue ethics[10], in particular with regard to practical wisdom, with that of positive psychology. The author expresses the need to propose positive role models that can stimulate students' aspirations, given the clash between personal values and those dictated by science or work which is typical of a Kantian morality focused on rules' fulfilment. The positive effects of a moral education based on this theory have been confirmed by different social psychological studies (Han, 2015, p. 451) and real stories of exemplary models can be a source of moral inspiration.

A concrete way through which universities and educational institutions can improve the financial innovation process is by promoting new role models in finance which are able to transcend the technical aspects of financial innovation and foster a better comprehension of the ethical repercussions of their task and how they can be addressed. One trailblazing example concerns the former trader and risk analyst Nassim Taleb and his Real World Risk Institute, the "first quantitative program embedded in the real world". Here again we can see a curriculum that is devoid of explicit ethics courses, yet the fact that the mission statement claims to "understand model error before you use a model" and declares that "when and if we model, we go from reality to models not from models to reality", suggests that the Institute is a good antidote to the risk of reified abstract knowledge typical of financial innovation processes. More generally, we argue that Taleb's intellectual project (contained in Taleb, 2016) is centred on the idea that financial operators should take risks to which they are also exposed, or where they have *skin in the game* ("Take risks you understand, don't try to understand risks")[11].

Another real case that could work for our aim is that of Markopolos, the quant who first exposed Bernard Madoff's Ponzi scheme. Markopolos's case is recounted by De Bruin (2015, p. 143) in order to underline both his quantitative knowledge as financial mathematician and his *epistemic* virtues – in particular of courage and inquisitiveness – to ask questions where others kept silent. According to De Bruin it is the combination of traditional mathematical skills reinforced by epistemic virtue which explains Markopolos's success.

10 Virtue Ethics is one of the main approaches in normative ethics, along with deontology and utilitarianism. Its origins in Western culture can be traced back to Plato and Aristotle. It was revived in the twentieth century through the works of Anscombe and MacIntyre. The virtue ethics implies a 'first person approach' as the one previously underlined.

11 See http://www.realworldrisk.com/

The Case of Neurotechnology

Obviously, the ethical challenges posed by technology do not merely concern financial innovation. Another intricate area of science is that of neuroscience where the use of new technologies (such as artificial intelligence) is spurring important advances in the understanding of the functioning of the mind and in finding cures for diseases or dysfunctions related to the brain[12]. Innovation comes with threats here too, such as the ability to manipulate free will (Yuste et al., 2017). The science community is currently debating these risks across several disciplines, and it is noteworthy how they refer to a case study on past threats from nuclear physics. In particular, they emphasise the need to set up a body analogous to the UN Atomic Energy Commission "which was established to deal with the use of atomic energy for peaceful purposes and to control the spread of nuclear weapons" (Yuste et al., 2017). While Sacharov's anecdote emphasized the cultural or ethical aspects of the individual agent, here it is worth dwelling on the institutional side, which is also important for facilitating ethical innovation processes.

Neuroscientists argue that "the mindsets behind technical innovation could be altered and the producers of devices better equipped by embedding an ethical code of conduct into industry and academia. A first step towards this would be to expose engineers, other tech developers and academic-research trainees to ethics as part of their standard training on joining a company or laboratory. Employees could be taught to think more deeply about how to pursue advances and deploy strategies that are likely to contribute constructively to society, rather than to fracture it" (Yuste et al., 2017). Lastly, they advance the idea of a Hippocratic Oath, analogous to the one taken by doctors, which commits neuroscientists to work for the good of human beings and to observe the highest professional standards.

While it is heartening to see how these scholars are dealing with purely ethical issues linked to technological development, this article wishes to show the deep "gap" that still characterises the world of financial innovation. We think that there are still many steps to take towards a socially responsible financial engineering process, even though the years since the financial crisis have seen an increased interest in issues related to the ethics of finance, including among practitioners (it is worth noting, for example, the Dutch "bankers' oath").

The Road Map for an Ethical Financial Engineering

In this article, we firstly took stock of this problem, underlining the philosophical and practical

12 We make reference to the BRAIN Initiative, the global project aimed at revolutionising our understanding of the human brain. https://www.braininitiative.nih.gov/

reasons why it is urgent to delve into the moral character of *quants* and financial engineers. Secondly, we briefly sketched some ideas that can hopefully contribute to defining the framework. In particular, the main insights can be summarised as follows:

1. Rethinking financial engineering education through the lens of virtue ethics and leveraging in particular *practical wisdom*. This virtue captures the moral side of an action, overcoming an exclusive focus on technical aspects. Moreover, virtue ethics is a first-person approach and as such fits particularly well with the "use" of role-models in order to take into account reality when designing products or strategies. As a result, the risks of a reified abstract knowledge would be reduced.
2. Involving universities and academic research centres in the processes of financial innovation which are currently the inaccessible domain of the research units of financial institutions. This would enrich the debate and the perspective, while limiting the damage that a reductionist approach could have on the financial world.
3. Adopting best practices and standards of conduct for financial engineers along the lines identified in the CFA. The experience accumulated over the years in facing the ethical challenges of financial advisors could work as a roadmap for similar strategies for quants and anyone else involved in the financial innovation process. This could eventually lead to a "Quants' Oath" that underscored their responsibility towards their clients and society.

These are all initial cues that need to be explored in depth in any future research undertaking. The hope is that just like nuclear physicists and neuroscientists, men and women involved in financial innovation could be "bilinguals" too. •

Table 1: Master in Financial Engineering

University	Programme	Business Ethics in the Programme	Link
Princeton University	Master's in Finance	NO	https://bcf.princeton.edu/master-in-finance/courses/
Baruch College, City University of New York	Master's in Financial Engineering	NO	https://mfe.baruch.cuny.edu/curriculum/
Carnegie Mellon University	Master's in Computational Finance	NO	https://www.cmu.edu/mscf/academics/curriculum/index.html
University of Chicago	Master's in Financial Mathematics	NO	http://finmath.uchicago.edu/page/required-courses
ETH Zurich	Master's of Science in Quantitative Finance	NO	https://www.msfinance.uzh.ch/en/courses/springsemester2019.html
Columbia	Master's in Financial Engineering	NO	https://ieor.columbia.edu/masters/financial-engineering/curriculum
MIT	Master's in Finance	Finance Ethics and Regulation	https://mitsloan.mit.edu/mfin/academic-excellence/mfin-curriculum
UCLA	Master's in Financial Engineering	NO	https://www.anderson.ucla.edu/degrees/master-of-financial-engineering/academics
Berkeley	Master's in Financial Engineering	NO	https://mfe.haas.berkeley.edu/academics/curriculum
Imperial College	Master's in Risk Management & Financial Engineering	Ethics and Professional Standards in Finance	https://www.imperial.ac.uk/business-school/programmes/msc-risk-management/programme/modules/
University of Oxford	Master's in Mathematical and Computational Finance	NO	https://www.ox.ac.uk/admissions/graduate/courses/msc-mathematical-and-computational-finance?wssl=1
NYU Tandon School of Engineering	Master's in Financial Engineering	NO	https://engineering.nyu.edu/academics/programs/financial-engineering-ms

Table 2: Ranking of MBAs[1]

1 Ranking MBA according to the Financial Times in 2019: http://rankings.ft.com/businessschoolrankings/global-mba-ranking-2019

Ranking MBA FT in 2019	School	Programme	Business Ethics in the Programme	Elective	Workers in finance %	Link
1	Stanford	MBA	Ethics in Management	Mandatory	35%	https://www.gsb.stanford.edu/programs/mba/academic-experience/curriculum
2	Harvard	MBA	Leadership and Corporate Accountability	Mandatory	25%	https://www.hbs.edu/mba/academic-experience/curriculum/Pages/required-curriculum.aspx
3	INSEAD	MBA	Business and Society	Mandatory	20%	https://www.insead.edu/master-programmes/mba/core-courses
4	Wharton	MBA	Legal Studies & Business Ethics	Mandatory	37%	https://mba.wharton.upenn.edu/mba-curriculum/
5	Ceibs	MBA	Business Ethics and Corporate Governance	Mandatory	20%	http://www.ceibs.edu/mba/core-courses
6	LBS	MBA	Managing Responsibility: Ethics in Work, Organizations and Society	Mandatory	27%	https://www.london.edu/masters-degrees/mba/programme-content/core-courses
8	Chicago	MBA	Business Environment	Mandatory	27%	https://www.chicagobooth.edu/programs/full-time/academics/curriculum

8	MIT	MBA	History, Environment and Ethics	Elective	15%	http://catalog.mit.edu/subjects/15/
9	Columbia	MBA	Executive Ethics	Elective	37%	https://www8.gsb.columbia.edu/courses/mba/2019/Spring
10	Berkeley	MBA	Ethics and Responsibility in Business	Mandatory	23%	https://mba.haas.berkeley.edu/academics/curriculum
11	Yale	MBA	Business Ethics/ Ethical Choices in Public Leadership	Elective	20%	https://som.yale.edu/elective-core-courses
12	IESE	MBA	Business Ethics	Mandatory	30%	https://mba.iese.edu/program/

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Financial Market Infrastructures, a Case of "Ethics Without Ethics"

Ethics & Trust in Finance
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Finalist

Louis de Diesbach
Belgium
Senior Manager, Cream Consulting & Student in Ethics and Philosophy, Université libre de Bruxelles, Brussels (Belgium)*

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

The role of Central Securities Depositories (CSDs) as Financial Market Infrastructures (FMIs)

Within the financial sector, there is an array of actors. They include retail and corporate banking organisations, payment companies, wealth management entities, trade repositories, custodians, securities settlement systems, and central banks. Within this diverse ecosystem, Euroclear Bank and Clearstream, both based in Europe, operate as the only international central securities depositories (ICSDs) in the world. The Depository Trust and Clearing Corporation (DTCC) also plays a major role in this financial ecosystem, although it is not an ICSD. These three institutions ' core activities are transaction settlement, asset servicing and collateral management, in addition to being a securities repository. Such activities make them, like all CSDs, a Financial Market Infrastructure (FMI), which has been defined "as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions." (BIS and IOSCO, 2012). This makes Euroclear or Clearstream. and FMIs in general, an essential platform for the market to function and at the same time, an outcome of the running of such a market (Aglietta and Orléan, 2002). As explained in "Plumbers and Visionaries: Securities Settlement and Europe's Financial Market" (Norman, 2007), CSDs and FMIs often play the role of plumbers, meaning that they are not

really working in daylight, in direct contact with laymen and customers. Rather, as an underground network of plumbing and infrastructures, they allow the system to run its activities in the best possible way. The stability of the international financial system is based on its structure and on the smoothness of the interactions between its stakeholders (Eichengreen, 2002). These infrastructures are often forgotten in the literature on ethics and finance, which is odd, bearing in mind the central place that they hold.

FMIs and Regulations

The role of FMIs, like plumbing or other infrastructures such as electricity grids or telecom networks, is to make sure that the financial market is working safely and efficiently (Norman, 2007). This will generate trust and confidence in the market and its infrastructure, while a malfunctioning market would undermine trust and potentially lead to a collapse of the monetary system (Aglietta and Orléan, 2002). Two different features are consequently brought into focus: competition and market power management, and risk management. These features are covered by various legal frameworks and regulations such as the EU's Central Securities Depositories Regulation (CSDR), whose role is to "promote safe, efficient and smooth settlement" and the CPMI-IOSCO Principles, which "provide guidance for addressing risks and efficiency in FMIs" (BIS and IOSCO, 2012). It is clear that "poorly designed and operated FMIs can contribute to and exacerbate systemic crises if the risks of these systems are not adequately managed, and as a result, financial shocks could be passed from one participant or FMI to others." (Urbain, 2019). This is why the CPMI-IOSCO Principles put a major focus on safety, resilience and risk-management, as indicated by Principle 2, on governance arrangements, and Principle 3, focused on risk-management frameworks (BIS and IOSCO, 2012). These are in line with the global movement towards more accountability and transparency in the financial sector, notably emphasised by the European Market Infrastructure Regulation (EMIR), the Markets in Financial Instruments Directive (MiFID) and other regulations. After the 2008 crisis, regulators put the focus on robustness and making sure that the financial system was as stable and transparent as possible. This focus sometimes also created tensions and conflicts between regulators and FMIs.

In the light of such regulations, one can say that transparency, resilience, efficiency and risk-management are the cornerstones of a robust and well-designed FMI. To make sure that the FMIs are indeed robust, they are often regulated and audited by various institutions such as the European Central Bank (ECB), the National Bank of Belgium (NBB) or the European Securities and Markets Authority (ESMA). The

effectiveness and efficiency of the financial market depend on various actors, which makes it sometimes difficult to regulate. On the other hand, it is precisely the number of actors that allows the system to be resilient and that safeguards business continuity, despite (or because of) a sometimes onerous regulatory framework. (Kuriata, 2011). The weight and complexity of these regulations can also lead to issues such as shadow-banking; indeed many stakeholders find some regulations such as MiFID "excessively complex" (Norman, 2007). The recent collapse of Archegos Capital Management reveals much about the banking industry: "Each bank may have felt comfortable with their exposure to Archegos, assuming they could always ditch its positions to cover themselves. But they failed to appreciate that if everyone has to dump tens of billions of dollars worth of equities, the collateral they may have embedded in their contracts is going to be wholly inadequate." (Wigglesworth, 2021). The problem was not the lack of compliance with the regulatory frameworks but the lack of depth of such frameworks and the transparency in their implementation. Both actors and regulators can find it hard to grasp the intricacies of the financial system and markets, making the relationship between these players difficult and complex; a curious mix of confrontation and collaboration, with both parties seemingly afraid of the power of the other.

ICSDs' position and policies – Euroclear

With such an environment in mind, the ICSDs mentioned above seek to reassure the various stakeholders, including regulators, clients and other partners, and reinforce their systemically important position as trustworthy CSDs that are able to operate as robust and reliable FMIs. These companies are fully aware of their systemic position and of the duties and responsibilities that come with it. In Euroclear's third "Our responsibility" report, it highlights five key areas: Governance, Marketplace, Environment, Workplace and Community. Interestingly, none of these aspects focuses on the global role of finance. Governance and Marketplace address regulators' concerns, such as more robust markets, the "due diligence process for the selection of new suppliers",and mitigating the risk of cyber attacks. Environment focuses on greener solutions for Euroclear's mobility and electricity needs, while the other two areas highlight on how to help people. The entire report devotes considerable effort to reassuring the public that Euroclear will fulfil its mission to operate as "an open and resilient infrastructure" which helps "clients cut through complexity, lower costs and mitigate risks" (Euroclear, 2020). Furthermore, the company's strategy puts the emphasis on "being a systemically important, resilient and robust infrastructure at the heart

of the financial industry's ecosystem", which also reflects the central focus of Euroclear's Materiality matrix: the company's top six priorities are directly linked with the "Marketplace" stream. Finally, the heart of Euroclear's corporate culture and values is found in the acronym "REACH", which stands for Respect, Effective, Accountable, Client-first and Helpful. These values underline Euroclear's commitment to be seen as a trustworthy partner which will ensure that the system works. The focus that the National Bank of Belgium (NBB) puts on "operational resilience, including business continuity" (NBB, 2020) seems to confirm that the major requirement for Euroclear is to make sure that transactions can happen the way they should, in line with the law and the various legal frameworks by which Euroclear and other FMIs are impacted.

ICSDs' position and policies – Clearstream

Clearstream's major focuses do not differ greatly from Euroclear's. It directly states on its website that one of the most important elements in the post-trade industry is trust and that "given the complexity, speed and quantity of assets involved [in the world's financial system], a fast, secure and trusted third-party is absolutely essential for settling transactions" (Clearstream). The Luxemburg-based ICSD presents itself as a tool that enables secure transactions and additionally ensures that they are processed as planned. Like Euroclear, Clearstream wants to move towards more sustainability in the financial ecosystem. However, in line with Euroclear, Clearstream's sustainability impact is limited. Despite offering "sustainable" services and financing, the company stresses that it is not the right actor to lead such a change. In the presentation of these products, Clearstream states that "fair, reliable and stable market infrastructures as well as transparent reporting and the availability of high-quality information are at the core of sustainable economies." The focus is on the transparency and trust which Clearstream can provide, but not on the means of achieving sustainable finance, or its ultimate purposes, which are clearly beyond Clearstream's scope. The major areas that the company highlights are indeed the same as those it was designed to promote (Norman, 2007).

ICSDs' position and policies – DTCC

It seems that all the major CSDs are "trapped" in the same dilemma. On the one hand, they have a lot of market power and influence to make things change but, on the other hand, they remain bound by their responsibilities to make the market work in a resilient, trustworthy and effective way. The DTCC faces the same issue. Its public communications suggest that it could be the right actor to

foster more ethical and sustainable finance but it remains constrained by its mission as an FMI to "provide stability and efficiency in the global capital markets" with a focus "on exceptional service" (DTCC). When addressing its "impact", DTCC emphasises that it can lead transformative change by "mitigating risk; advancing cutting-edge technology; collaborating to solve industry-wide challenges; driving down costs and creating efficiencies". Once again, the focus is on the efficiency and resilience of the market. It is understandable that such companies struggle to have a major impact on sustainability when they are ultimately only used for their plumbing and safeguarding technical expertise. Adding to their constraints, they must comply with various laws and regulations which clearly define their roles and responsibilities. In this respect, DTCC's "ethical business practices" only focus on compliance with no mention of new products, partnerships or investments (DTCC, 2020), purely simply because these are not part of the regulated remit of CSDs.

The instrumentalist view of CSDs

In the intense debate about ethics and finance – or, more specifically, ethics in finance – we strongly feel that FMIs and CSDs occupy a special place, stuck between a will to enact change and limited ability to initiate that change. In a purely instrumentalist view, Euroclear, Clearstream, DTCC and other FMIs, like other infrastructures or commodities, can and should be seen as tools whose main – and perhaps sole – purpose is to operate the way they were designed to work. This purpose can also be seen as a closely regulated duty which is the reflected by the mission statements, values and corporate responsibilities discussed above.

However, in addition to this "instrumentalist' view", FMIs also have a duty to make the market more efficient and resilient, in line with the regulations previously mentioned. While the companies' first task is purely operational, the second task has a qualitative aspect. For example, several features need to be present to achieve a competitive financial market. One such feature is transparency, the reason why the EU implemented MiFID and MiFID2, which aim to make EU financial markets "more robust and transparent." A key point underlined by the directives is that "the rules strengthen the transparency requirements that apply before and after financial instruments are traded, for instance when market participants have to publish information regarding the prices of financial instruments. These requirements are calibrated differently depending on the type of financial instrument" (EU, 2014). More information on securities liquidity in the market will make it safer and will reduce the risk

(Duchêne and Zaoui, 2012). Furthermore, the asymmetry of information and understanding about the market usually makes it less transparent and less effective (Kuriata, 2011), while "perfect information" would increase competition and efficiency. Liquidity is thus a serious issue for all FMIs, which have invested heavily in this area. Euroclear's LiquidityDrive (Euroclear, 2020) is one example, while Clearstream has developed innovative solutions for the ETF market (Clearstream, 2019). In both cases, these ICSDs have worked hard to achieve this qualitative aspect of their duty by supporting a better financial market.

This dual role puts Clearstream and the other companies in a dual position, since maintaining and improving the network are two very different roles with a range of ethical implications. Moreover, the various conflicts of interest that may arise within the industry is itself an ethical challenge to find "common ground" that will suit every party (Payne, 2007). Overall, it seems that both the regulators and the CSDs want to foster transparency, risk-aversion and accountability to enable the market to function smoothly and remain stable, resilient and effective. , However, such a dual role, involving both maintenance and qualitative improvement, may have ethical implications which surpass the instrumentalist view of FMIs.

Ethics without ethics

As stated above, we believe that FMIs can be seen purely as tools or infrastructures within the financial system. When regarded as such, FMIs need specific ethics and ways to evaluate their moral behaviour. Retail and corporate banks and wealth management firms companies can have major environmental or societal impacts based simply on what they choose to invest in. By contrast, FMIs do not face similar ethical dilemmas when seen as instruments guaranteeing market stability and resilience. FMIs are not confronted with the question of the choice or decision that is central, and standard, in economy theory (Mardellat, 2013). On the one hand, Euroclear or Clearstream can never refuse an issuer, except on risk-based or legal grounds, just as a hammer cannot choose what it will be used for. On the other hand, it is important for the market that the CSDs maintain this neutrality in order to enable other stakeholders to choose and decide. As noted by Kuriata, "financial markets contribute to the positives of life when their functions perform correctly and efficiently" (Kuriata, 2011); and as Norman puts it: "securities markets are only as good as the infrastructure that supports them" (Norman, 2007). One can therefore say that the most ethical way of working is to help the market run as it was designed, in order to pursue and promote ethical behaviours and outputs. As

with other infrastructures, one can design specific ethical rules based on the need for an efficient and effective operation, as one might expect from any instrument or tool.

Money as a tool

Within the financial world, one of the most famous tools that divides philosophers and economists is money (Duchêne and Zaoui, 2012). In a pure instrumentalist view, money can be simply seen as a tool or an instrument that creates a pledge of security. Furthermore, Mardellat, when analysing the role of money in the "three pure forms of economy philosophy" (Mardellat, 2013), argues that money is ultimately always seen as an instrument facilitating relationships and connections; "money is what money does". Therefore, Duchêne and Zaoui contend that the philosophical discourse around money is purely a technical one (Duchêne and Zaoui, 2012). Under these circumstances, ethics based on feelings, such as the ethics of care, are simply "too beautiful to work" (Duchêne and Zaoui, 2012), especially since a tool, or a network, has no feelings.

As an apparatus or a technique, money is trusted and used *because* it does not have any feelings – and therefore because we all know that it will always be accepted (Aglietta and Orléan, 2002). With a $10 bill, you can either buy a pair of socks, beer, cocaine or a t-shirt that was made in China or Bangladesh by underaged workers. Money does not care, and that is precisely why people trust it. As a financial instrument, money does not possess any intrinsic ethics or values; call it "operational ethics" or, more bluntly, "ethics without ethics". The neutrality of money and FMIs mean that they do not have the influence of actual phenomena (Duchêne et Zaoui, 2012). For example, if you take a hammer, you can use it to fix something or to smash someone's skull. The hammer's neutrality means that it has no influence on how one would – or should – use it. The same goes for FMIs. It is politics which should define what can or cannot be done with FMIs and money, just as it is politics – or more specifically laws – which ensures that it is illegal to smash someone's head with a hammer.

Limits of the pure instrumentalist view

However, although the comparison between an ICSD and a hammer brings valuable insights, it also has its limits. Firstly, as noted above, an ICSD works more as a network, with interconnections and interdependencies which a simple hammer does not possess. Furthermore, this network is so complex that it cannot be easily replaced. Such a special place in the financial ecosystem gives ICSDs a lot of power but also brings significant responsibilities. Although the companies usually take these responsibilities seriously, they can at times overlook the power that goes

with them. Euroclear and Clearstream maintain a peculiar relationship with regulators, as if both parties feel they are David facing Goliath. In reality, both have substantial power and should seek to collaborate rather than confront each other. The "ethics without ethics" framework is thus well-adapted to fit Euroclear and Clearstream's circumstances, since it allows ICSDs to remain neutral in possible market disputes. By contrast, the companies' risk-adverse culture amounts to abandoning neutrality by denying their own power.

The hammer comparison also falls short in grasping the qualitative aspect of the ICSDs' work. As explained above, their role is not only to maintain the plumbing but also to make it more efficient. The hammer does not own any responsibility for its own self-improvement while ICSDs are duty-bound to strive continuously to ensure that the market thrives achieves greater resilience, transparency, and so on. This duty might also impose limits on the ethics that we presented, since any improvement requires a decision to move in a particular direction. For example, when ICSDs decide to invest in cybersecurity or to devote money to the development of new products, that decision can never be neutral. The efficiency of the market will be affected by the fact that they decide to invest in one product rather than another. Although that aspect does not necessarily overthrow our "ethics without ethics" framework, it establishes a ceiling for the model, while also defining the limits of purely instrumental FMIs. Their decisions will impose new norms which will directly influence the neutrality, resilience and efficiency of the market. Such decisions are also a reminder for the ICSDs of their own power and responsibilities. Thus, they can close the loop of "ethics without ethics" - the pure instrumentalisation of FMIs – which should allow the market to work efficiently and as it was designed to operate. This is only possible when regulators and these infrastructures sit around the table to discuss, to share, and to make the system move forward.

A Kantian approach to "ethics without ethics"

The pursuit of such "ethics without ethics" falls within the scope of Kantian ethics. In the *Groundwork of the Metaphysics of Morals* (1785), Kant invites us to "act only according to that maxim whereby [we] can at the same time will that it should become a universal law." In the further development of his categorical imperative, Kant introduces the test for universality: would there be a contradiction in everyone, always and everywhere, acting according to this maxim? One possible contradiction would be that the universalisation of the maxim makes the realisation of the action impossible. Kant gives the example of an individual applying for a loan while already knowing that he would not be able to repay it. When trying

to universalise such a maxim, we quickly realise that the non-repaying of the loan would lead to banks never granting loans at all and that it would, therefore, make the realisation of the action (applying for a loan which the lender already knows he cannot repay) impossible.

We believe that "operational ethics" – or "ethics without ethics" – follow the same reasoning in the case of the guarantees-offering and network-maintaining services that FMIs provide. If a CSD decided, for a reason outside the legal framework, to refuse either a transaction settlement or to give access to a new issuer, it would directly forfeit the faith and trust that financial institutions have invested in it. The same is true for money and the use of the $10 bill mentioned above. When trying to universalise such a way of working, we are rapidly faced by the same issue as our "non-repayer": the impossibility to act in such a way ever again. This could explain why the regulatory framework ensures that such cases do not happen; for example, CSDR clearly defines access rules, price transparency, and safety considerations. Similar definitions are found in Euroclear's REACH values and in DTCC's capabilities statement. All these companies focus on reassuring stakeholders that the service will keep on running as it should.

A dual operational and qualitative role

The categorical imperative stated above should always lead Clearstream, Euroclear and others to invest in the best possible way to allow the market to work the way it should. This will uphold the neutrality, fairness and efficiency of the market and bring "operational ethics" into force to maintain and safeguard these features. Although the qualitative and normative aspects of the ICSDs' decisions are not encompassed in the "ethics without ethics" framework, the latter cannot be fully implemented if the companies deny their qualitative role within the financial market. Given the limited number of FMIs, they have a major responsibility to allow "ethics without ethics", even though it is this ethical "non-framework" which allows them at times - voluntarily or not – to bypass that responsibility.

Such complex but nonetheless crucial environments need to be monitored closely. Like money, FMIs are what they do, so one must pay close attention to the regulatory framework that will then define and frame the activities of ICSDs and other FMIs. Money, as a tool, is a public good (Aglietta and Orléan, 2002; Duchêne and Zaoui, 2012) and Clearstream even describes itself as a "public service mission". Therefore, the supervision and the framing of financial activities fall under the power of the sovereign (Duchêne et Zaoui, 2012). The heavy regulatory weight that rests on ICSDs' shoulders is thus legitimate since the use of the FMI as a tool remains a political responsibility.

Partnerships and collaboration

"Ethics without ethics", when seeing FMIs as tools, bring us back to the philosophy of technology. As a purely instrumentalist perspective, the philosophy of technology always applies to the person using it, rather than the technology itself (Hottois, 1984). As tools become more efficient and transparent, just like financial markets, users (individuals, private and public institutions) tend to forget their existence and how they work. Only results and outputs matter. Thus the philosophy of technology applies to FMIs when they are only seen as tools working within the distinctive framework of "ethics without ethics".

However, the role of philosophy in the case of FMIs is not simply to state that "financial markets are not working". It is to ask the right questions and propose solutions. We agree with the Belgian philosopher Gilbert Hottois that part of the answer to the problem of technology can be found in Aristotelian prudence – *phronesis* (Hottois, 1984). Given the financial environment and ethical dilemmas that FMIs face, we believe that this "practical virtue" rests in collaboration and discussion between the major stakeholders.

Discussion between public and private entities

Today, the lack of collaboration makes the situation of CSDs sometimes difficult to bear. Their dilemma could be summarised as follows: in order to make the market and the network as smooth and resilient as possible, they need to make profits that can be invested in further development. At the same time, to make the market as smooth and transparent as possible they may also need to offer some services for free. Faced with these obligations, the companies hide behind their instrumentalisation and try to devise distinctive solutions that usually lead to maintaining the existing market. That is not how one fosters change, especially towards more sustainable, inclusive and diverse finance. Yet there is an escape from this dilemma. Governments and politicians have a lot more power to drive change than individuals or small communities (Duchêne and Zaoui, 2012), and as money and FMIs can be seen as public goods or services, a paradigm shift is possible. The "ethics without ethics" framework reactivates the need to question political actions and choices. It also reaffirms the fundamental requirement for collaboration and discussion, especially given the limits of pure instrumentalisation described above. If EU member states or other countries simply decide to develop a new CSDR, without further consultation or examination with CSDs, this will simply increase the tension between existing entities, leaving Clearstream, Euroclear and other companies in an awkward position. We believe that the pure instrumentalist view of FMIs needs to be superseded by partnerships and a shared will to build a better financial systems. When only seen

as tools, "ethics without ethics" will always prevail and block any possible evolution of the financial landscape. FMIs have a decisive role to play in the evolution of such a landscape, but this will not be possible as long as they are seen (or see themselves) only as a plumbing network.

Public consultative ethics committees

One of many potential solutions is the creation of public consultative ethics committees within each FMI or country. We support this proposal. Such a committee, including gathering officials from the ICSD, external experts, philosophers, and perhaps even lawyers or teachers, could foster the necessary collaboration towards the common good of the market. Such a committee could also reinforce collaboration between FMIs and institutions, with some "external experts" appointed from the NBB, the EU, or other major players such as SWIFT. Just as the Comité consultatif de Bioéthique Belge (CCBwas created to give advice and to inform on bioethics issues, the financial system also needs to put ethics centre stage. The establishment of such a committee will obviously face many obstacles, such as the difficulty of finding neutral members and guaranteeing their independence. However, the dilemmas faced by FMIs clearly highlight the need for interdisciplinarity, collaboration and collective intelligence. A common ethics committee could be a major asset to help overcome the problems created by "ethics without ethics". •

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Ethics and Trust in Virtual Currencies

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Finalist

Bessie O'Dell
United Kingdom
DPhil Student,
*University of Oxford**
Oxford (United Kingdom)

* The views expressed herein are those of the authors and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

The rise and fall (and rise again) of virtual currencies

"Money makes the business world go round. Yet money is more than cash." (Dierksmeier and Seele, 2018, p. 1)

When we think about money, we often think about cash – tangible banknotes, coins, or an indication of current assets (which can be readily turned into cash). Money is at the centre of the financial world. It is used as payment for goods and services, for people and organisations to pay their taxes, for the repayment of debts, and for investment. Yet money is much more than cash. Indeed, emerging forms of money, such as virtual currencies, are presently enjoying a meteoric, if undulating, rise.

In May 2021, Dogecoin - a digital currency based on an internet meme, which was created by software engineers as a "joke" in 2013 - jumped in value by 30 per cent within 24 hours after being endorsed on Twitter by Tesla's CEO Elon Musk (Bambrough, 2021) (see *Figure 1*). Similarly, the renowned Bitcoin has enjoyed a spectacular rise since its inception in 2009 as an "electronic payment system based on cryptographic proof *instead of trust*," and an alternative to traditional financial instruments (Nakamoto, n.d.; emphasis added). Bitcoin has endured a volatile and undulating trading history since its inception, but still, its price climbed to a new high of $63,729.50 in April 2021. However, this success story has not come without criticism. Most notably, Nobel prize winning economist Paul Krugman went as far

as to denounce the cryptocurrency as "evil" in a 2013 article for *The New York Times*, arguing that it "remains completely unclear why Bitcoin should be a stable store of value" (Krugman, 2013). This opinion was shared by Benoît Cœuré, a member of the Executive Board of the European Central Bank (ECB), who has highlighted the "plentiful" problems of Bitcoin, describing it luridly as "the evil spawn of the financial crisis" (Jones, 2018).

The paradoxicality of virtual currencies

There is a degree of paradoxicality in Bitcoin describing itself as being based on cryptographic proof instead of trust. Arguably, trust is almost exactly what is required for a consumer to purchase, utilise, and especially to invest in, the decentralised, peer-to-peer cryptocurrency. As with all cryptocurrencies in circulation, Bitcoin is "not backed by any government or other legal entity" and is "not redeemable for gold or other commodity" (Gribberg, 2011). Therefore, its value is largely driven by speculative interest – hence its volatility. Bitcoin's inventor is also an unknown entity, with the original white paper outlining its conception written by "Satoshi Nakamoto", which is presumed to be a pseudonym, having never been credited to a particular individual. Yet Bitcoin continues to grow in popularity, alongside a host of other cryptocurrencies such as Ethereum and XRP. For example, in August 2019, 14 cryptocurrencies, ranging from Bitcoin and Litecoin to TRON, had a staggering market capitalisation of more than $1 bn (Giudici, Milne and Vinogradov, 2020.

The paradoxical nature of cryptocurrencies does not end there. On the one hand, such currencies have been credited with being a "solution to mitigate transaction costs and reduce poverty", as well as being "beneficial in the context of debt crises and hyperinflation" (Mbarek, Trabelsi and Berne, 2020, p.29). They might also provide additional personal and societal benefits, such as increasing people's financial autonomy. Technologically speaking, virtual currencies also allow for fast, secure, anonymous and international transactions, without relying on an intermediary such as a bank.

Conversely, virtual currencies have been beset by controversy and by links to unethical practices. Chief of these are claims that Bitcoin and related currencies have a significant, negative impact on the environment, stemming from the substantial amount of energy required for "data mining". Further concerns centre around the unethical use of cryptocurrencies, ranging from "virtual money laundering and tax evasion", to "the financing of illegal activities (i.e., illicit products, terrorist financing) and cyber attacks" (Mbarek, Trabelsi and Berne, 2020, p. 29).

Figure 1. The Dogecoin logo. 'Dogecoin' is an open-source peer-to-peer digital currency (cryptocurrency) which was originally created as a "joke" by software engineers Billy Markus and Jackson Palmer.

Despite a substantial number of news articles on the topic, there is very little academic literature focusing on the ethics of virtual currencies. One article (Mbarek, Trabelsi and Berne, 2020) provides a helpful overview of the virtuosity of virtual currencies and the environmental issues they raise. However, it lacks substantive critical content in several areas, with several topics only receiving a cursory nod. A systematic review conducted by Corbet, Lucey, Urquhart and Yarovaya (2019) also highlights a lack of focus on the ethics of virtual currencies. Of 92 studies surveyed, none tackled ethics. Conversely, the financial, technical, regulatory and behavioural aspects of virtual currency have been relatively well documented in the literature (see for example, Briere, Oosterlinck and Szafarz, 2015; Shin, 2008; Tu and Meredith, 2015; Wang and Mainwaring, 2008).

Similarly, despite virtual currencies being emerging, novel and largely unregulated technologies, there has been very little research examining the dynamics of trust at play. Ultimately, the underlying attributes of the technologies that drive trust in cryptocurrencies are not well understood (Marella, Upreti and Merikivi, 2020). Yet trust is clearly crucial to financial transactions and payments, as noted by Blommestein (2006, p.180): "without trust, financial markets cannot function efficiently."

This essay is therefore divided into two sections, and will seek to answer the following questions:

1. What are virtual currencies, and are they ethical?
2. To what extent are virtual currencies trusted, and should they be?

What are virtual currencies, and are they ethical?

Virtual currencies

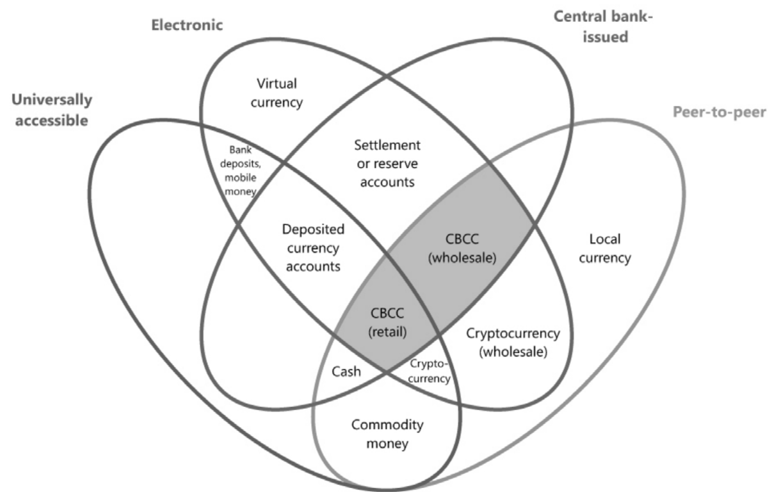
Virtual currencies are a type of digital currency which use financial technology (FinTech) and are a

virtual representation of money. Most commonly, they take the form of electronic "tokens" or "coins". They are also commonly referred to as "cryptocurrencies" which are in fact virtual currencies. The most well-known example of a virtual currency is Bitcoin, which explains why many commentators incorrectly assume that Bitcoin and virtual currency are one and the same.

By contrast, "digital currencies" is an umbrella term for any means of digital payment, which can include cryptocurrencies issued by private entities, central bank digital currencies and several other forms of digital money (Shi and Sun, 2020). They were introduced as a convenient way to carry out financial transactions globally, but also brings their own ethical and trust considerations, such as the potential introduction of central bank digital currencies (CBDC). Digital currencies are sometimes called "electronic money", "electronic currencies" or even "virtual currencies". Much of the discussion around digital currencies is in fact centred upon cryptocurrencies.

Virtual currencies often utilise, but are distinct from, electronic payments, which instead refers to payments using digital instruments. They bear the same functional properties as physical money, in that they can be used to make direct

Figure 2. The money flower: a taxonomy of money (Linnemann Bech and Garratt, 2017). Virtual currency is a universally accessible, peer-to-peer form of money, which intersects with (but is distinct from) central bank-issued forms of money



purchases of both services and physical goods, as well as be used online. However, virtual currencies do not have a physical location, and nor are they bound to a tangible asset, in the way that cash, for example, is backed-up by gold reserves. By contrast, virtual currencies make use of a complex cryptographic system. Within this system, the currency is located on a blockchain network, which functions as a digital ledger of transactions and a distributed system of recording information. The currency can be accessed using public and/or private keys stored on either a web-based or hardware-based digital wallet, such as on a computer or a mobile device. These are often referred to as "cryptocurrency wallets" or "crypto wallets", and crucially do not store the cryptocurrency or digital currency. The perceived benefits of virtual currencies are that they present a secure, fast and international mode of money transfer, without relying on an intermediary.

Ethics and virtual currencies

The Cambridge English Dictionary definition of "ethical" is something which relates "to the beliefs about what is morally right and wrong" (Cambridge English Dictionary, 2021). But what exactly does it mean for something to be morally right or wrong, and why might it be important for virtual currencies to be so? Can inanimate and indeed, digital objects hold a moral status, or is it ultimately the actions of humans that are under scrutiny? Furthermore, if something has both ethical and unethical attributes, such as a currency being simultaneously used to finance criminal activity and charity work, to what degree can it be considered "ethical'"? Philosophers, particularly in the Western tradition, have discussed comparable questions throughout history. Plato, Aristotle and Hume all considered the question of whether there exists objective, rationally defensible standards of right action (Cottingham, 2008). The difference now is that ethical considerations are being applied in new ways to emerging technologies. As a result, new research fields have emerged, ranging from the philosophy of technology and computer ethics to machine ethics.

Discussion of the ethicality of virtual currencies is important. Firstly, it may be helpful knowledge for ethically minded people and organisations who might be considering using, investing, or being involved in the manufacture and distribution of virtual currencies. There are also real-world implications to consider. For example, in one empirical study, researchers used a text analytic approach to measure the extent to which "ethical" and "unethical" words were used in a discussion related to Bitcoin on Twitter, in order to determine whether there was a connection between ethics and cryptocurrency valuations. They found that the frequency of an

unethical discussion about Bitcoin was negatively associated with its price (Barth, Herath, Herath and Xu, 2020).

In this paper, we argue that virtual currencies, in the state that they presently exist, do not hold a moral status, and thus are not unethical or immoral or alternatively ethical and moral. Rather, ethical issues can arise from the use, or misuse, of such currencies. While there are many ethical issues that can, and should be considered, three key areas are highlighted below: the environment and energy use; broad social implications and blockchain ethics; and lastly, the ways in which blockchain technology can be, and is being, used to do good.

The environment and energy use

On 21 August 2018 Arvind Narayanan, an Associate Professor of Computer Science at Princeton University, provided written testimony to the United States Senate Committee on Energy and Natural Resources on the energy efficiency of blockchain and similar technologies. He described how for "most prominent public blockchains, mining involves the computation of a large number of mathematical calculations, called hashes, in parallel,". Thus, "substantial energy is required to operate the computing devices as well as to cool them to keep them within their operating temperature limits" (p.3). The extensive energy-intensive process required for "Bitcoin mining" involves important work being carried out to check all monetary transactions, which in turn creates Bitcoins as rewards.

It has been reported that the energy used to create Bitcoin alone is equivalent to the total energy consumption of the Netherlands, which has a population of 17.5 million. It is also equivalent to the annual carbon footprint of Argentina, as well as being comparable to Ireland's total electricity consumption (O'Dwyer and Malone, 2014).

The real-world impact of mining virtual currencies is already evident. For example, Iran recently (27 March 2021) announced a four-month ban on cryptocurrencies such as Bitcoin after several of its cities experienced unplanned blackouts, caused by energy-consuming mining. According to the BBC News (2021a), an estimated 4.5 per cent of all Bitcoin mining takes place in Iran, with President Hassan Rouhani detailing that 85 per cent of cryptocurrency mining is unlicensed and thus draining more than 2GW from the national grid each day. An assumption could therefore be made that, as well as having a detrimental environmental impact, data mining from cryptocurrencies is having a negative effect on some people's daily living conditions and potentially their happiness and wellbeing.

There are also long-term impacts to consider, the chief of which is climate change. Arguably,

humanity has a moral obligation to conserve the earth's ecosystem, both for the current generation and for those who follow. There are two main philosophical arguments as to why this might be the case. The first is that environmental conservation is important because of human dependence: that we need the earth and its human and animal inhabitants to both survive and thrive. Indeed, according to the former UN Secretary-General Ban Ki-moon, protecting the environment is an "urgent moral imperative", especially given that "climate change is intrinsically linked to public health, food and water security, migration, peace and security" (United Nations, 2015).

A secondary argument follows, whereby conserving the ecosystem is important for the ecosystem, which merits protection and nurturing, even in the absence of human need or dependence. The philosopher Aldo Leopold has argued that "a thing is right when it tends to preserve the integrity, stability, and beauty of the biotic community; it is wrong when it tends otherwise"(Cottingham 2008, p.585). Many observers and commentators have taken issue with this position. For example, Kant argued that man has "no immediate duties towards animals, but rather our duties towards animals are merely indirect duties towards humanity" (Cottingham, 2008, p.576).

In any case, evidence suggests that the energy consumption of cryptocurrencies is such that it could have an impact on global warming. For example, one study in *Nature Climate Change* showed that projected Bitcoin usage, "should it follow the rate of adoption of other broadly adopted technologies, could alone produce enough CO2 emissions to push warming above 2 °C within less than three decades'" (Mora, *et al.*, 2018). Conversely, to some, the benefits of cryptocurrency outweigh the harm. For example, some people argue that Bitcoin derives most of its electricity from renewable energy sources (see for example, Frisby, 2021). However, this is not well documented in academic literature.

Social implications of virtual currencies

On 26 May 2021, the UK's Advertising Standards Agency (ASA) banned an advert by cryptocurrency company Luno which it deemed to be misleading. The ASA ruled that the advert omitted important risk warnings, and was "irresponsible" in encouraging inexperienced consumers to purchase Bitcoin. "We understood that Bitcoin investment was complex, volatile and could expose investors to losses", the ASA said. However, it continued, "that stood in contrast to the ad[vertisement]. The audience it addressed, the general public, were likely to be inexperienced in their understanding of cryptocurrencies" (BBC News, 2021b). Virtual currencies are ultimately "money

without institutions". They can bring with them some positive consequences, as discussed below. However, they can also present an ethical dilemma when targeted at naïve investors.

Virtual currencies have been linked to an array of sinister unethical behaviours and practices, ranging from virtual money laundering and tax evasion, to the financing of illegal products and activities, including terrorist financing, and to cyber-attacks. These practices are so widespread that they have spawned the term "crypto-crime". For example, cryptocurrencies are often used on the "Darknet" or "Darkweb", an overlay network within the Internet which is only accessible with specific software. Bitcoin, it has been argued, has become "the currency of choice for cybercriminals", given that "distinctive characteristics of decentralisation and pseudo-anonymity are also attractive to criminal actors in general" (Brown, 2016, p. 327). By extension, the Darknet seemingly facilitates this criminal activity.

Blockchain ethics: an opportunity for redemption?

Much of the concern around environmental and social impacts stems from the use of blockchain technology. This is because it is the feature of virtual currencies that is most energy intensive, and which also facilitates the type of unethical behaviour which thrives on anonymity. Historically, there has been a notable lack of research on blockchain ethics. However, there have been recent efforts to identify the ethical issues surrounding blockchain, and to propose a conceptual framework for blockchain ethics following discussion with stakeholders (Tang, Xiong, Becerril-Arreola and Iyer, 2020). In a systematic literature study on blockchain ethics, Hyrynsalmi, Hyrynsalmi and Kimppa (2020) highlight that "the area is swiftly maturing", yet there is a lack of usable ethical tools, methods and frameworks for blockchain ethics. Furthermore, their study shows that blockchain ethics discussion often remains artificial. They therefore call for more "concrete usable tools—for the practitioners and scholars", as well as a "deeper understanding of relevant ethical concerns" (p.145).

Some scholars have sought to highlight and understand the ways in which blockchain technology can be a source of social good and be used in ethically acceptable ways. For example, Lapointe and Fishbane (2019) consider how blockchain might allow for the expanding of access to services towards people who do not have formal identity credentials or credit history. As one example, BanQu's economic-identity blockchain "aggregates personal identifiers, such as financial transaction histories, property records, trust networks, and education records", so that people are able to "develop a portable and vetted personal history that gives

them access to formal services" (p.56). In addition, blockchain has the potential to be a force for good beyond banking and finance. For example, it could enable the protection of vital records in digital registries, enable secure mobile voting, help to prevent human trafficking, and improve medical research and healthcare (*ibid*).

Beyond academia, positive action is already being taken to steer virtual currencies in an ethical direction. For example, in May 2021, it was announced that a new Bitcoin Mining Council had been created in order to improve the cryptocurrency's sustainability, following a meeting of "leading" Bitcoin miners and the ever-present Elon Musk (BBC News, 2021c). Meanwhile, more ethical options for virtual currencies are becoming available, such as FairCoin (https://fair-coin.org), which claims to require "much less energy than other blockchains", while enabling faster transactions. As well as laying claim to very low power consumption, even with hundreds of transactions per minute, FairCoin also looks to support fair business values and models.

Furthermore, some commentators have argued that the focus on issues such as the dark side of the darknet has been overdone. For example, one qualitative study found that current academic studies and media reports tend to highlight how the anonymous nature of the Darknet is used to facilitate criminal activities. However, the characteristics of the Darknet also "provide a wide range of opportunities for good as well as for evil". This is enabled, they suggest, by various characteristics that are also seen to cause harm, but which are "rooted in the Darknet's technological structure", such as "anonymity, privacy, and the use of cryptocurrencies' (Mirea, Wang and Jung, 2019, p.102).

To what extent are virtual currencies trusted, and should they be?

Trust has been described as the "social glue" between the known and the unknown, and something which matters more than ever in the digital age (Botsman, 2017; 2020). In its most basic form, trust can be envisaged as a dyadic conception, focused on specific actions between people, where all parts are necessary. For example, "A trusts B to do X" (Hardin, 1996). Theoretically, this can also apply to dynamics which include non-human actors. Indeed, a concept identified as "e-trust" has been adopted by some researchers seeking to delineate the more generic ideal of "trust" from trust specifically developed in digital contexts and/or involving artificial agents (Taddeo and Floridi, 2011).

There are of course, many forms of trust, ranging from interpersonal trust (the perception that others will not harm your interests) to institutional trust (confidence in institutions). A related, yet distinct concept, is that of "trustworthiness" – the extent to which something

or someone is deserving of trust or confidence (Hardin, 1996).

What does it mean then to trust a virtual currency, or to find it trustworthy? Furthermore, what do we know about whether people trust virtual currencies? We might reason that in this context, there would be an expectation that the currency was fair, fit for purpose, and fulfilled its intended use or uses. These might include being secure, transferable and anonymous.

Considering the many news stories, and academic articles denouncing virtual currencies, one might think that this would affect how trustworthy they are considered to be, and how trusted they are in practice. Indeed, as Barth, Herath, Herath and Xu note (2020), consumers are sensitive to the ethicality of virtual currencies, and have been shown to respond negatively, with the price has falling, when a currency is perceived to be unethical. Yet despite these overarching concerns, many people continue to utilise, and invest in, virtual currencies, indicating some degree of confidence in their trustworthiness.

Original research now exists which seeks to understand and explain the trust placed in virtual currencies. For example, one research paper by Marella, Upreti, Merikivi and Tuunainen (2020) analysed 1.97 million discussion posts across several online forums related to Bitcoin, such as Cryptocurrency Talk and BitcoinTalk Forum. They found 11 different attributes related to three technology constructs that are significant in creating and maintaining users' trust in Bitcoin. These included security, stability, knowledge, regulation, decentralisation, investment, profitability, alternative currency, openness and transfer.

One key explanation for the trust placed in virtual currencies is the stark contrast they provide with traditional financial institutions, which suffered a particularly steep demise in trustworthiness following the 2007-2008 global financial crisis. Marella, Upreti, Merikivi and Tuunainen (2020) highlight that the use of cryptographic techniques increases the users' trust in cryptocurrencies, while traditional financial services benefit more from institutional trust. Thus, "in the absence of basic legal and institutional premises, cryptocurrencies demand trust, not in people but in technology, as the security of financial transaction depends upon the underlying technology" (p.261).

Conclusion

In exploring the ethics of virtual currencies, and the trust placed in them, this paper has sought to answer the following questions:

What are virtual currencies and are they ethical?

Firstly, we highlighted that several terms are often conflated with "virtual currencies", such as "digital currencies" and "cryptocurrencies".

Nonetheless, virtual currencies are a distinguishable concept in their own right; for example cryptocurrencies are simply a sub-type of virtual currencies. These distinctions matter, because different forms of digital currencies (the umbrella term for virtual currencies) present their own ethical challenges. We also showed how it is the underpinnings of virtual currencies, such as their use of blockchain technology, which largely give rise to ethical considerations.

We argue that virtual currencies ought not to be judged as possessing moral standing. Instead, it is their uses (or the individuals who use them in certain ways, who ought to be scrutinised. In answer to the question of whether virtual currencies are "ethical", we suggest that there is a complex interplay of both ethical and unethical practices and consequences when using virtual currency, including an array of environmental and social factors. While these factors are not intended to be a comprehensive list, they nevertheless highlight key areas of focus and contention.

Whether or not one understands something to be "ethical" when it possesses both ethical and unethical components will depend on one's philosophical and moral leanings. The important takeaway, however, should be that clearly unethical issues, such as environmental deterioration and financing of crime, ought to be addressed by issuers of virtual currencies. As highlighted, some work is already being carried out, for example with the creation of ethical cryptocurrencies such as FairCoin.

To what extent are virtual currencies trusted, and should they be?

Secondly, we sought to understand whether virtual currencies are trusted by users, and whether they should be. The substantial, continued rise in the popularity of virtual currencies, particularly, cryptocurrencies, indicates that people are trusting enough to either invest in, or at least experiment with the idea of, virtual currencies, whjch seem to provide an attractive alternative to traditional institutions and financial instruments. Furthermore, their volatility is well documented, and perhaps even expected. It remains to be seen whether virtual currencies *should be* trusted over time, and whether, as the memory of the global financial crisis fades, they will continue to be trusted. Perhaps they will continue their meteoric rise, in which case virtual currencies may one day be the "money [that] makes the business world go round.". •

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Ethical Considerations Regarding the Innovative Potential of Fintech

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Finalist

Oliver Alberto Vasquez Soliz
Bolivia
Junior Researcher Collaborator, ECRI (Ethics in Finance & Social Value), University of the Basque Country, Spain*

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

Introduction

The onset of the global financial crisis in 2008 amid increasing dependence on technology has led to a significant transformation of the financial landscape with the rise of Fintech companies. This phenomenon has entailed the restructuring of the financial services industry through innovative business models that offer highly efficient and disruptive solutions (Gomber et al., 2018). It has brought about new forms of disintermediation, resulting in reduced prices and fees for financial services, coupled with improved quality (Zetsche et al., 2017).

The Fintech market has experienced substantial growth, reaching a value of nearly $526bn in 2020, despite the challenges of the pandemic (World Bank, 2020). This growth presents an opportunity to reshape traditional financial services and embrace more inclusive innovation across different settings.

Indeed, it aligns with UN Sustainable Development Goal 16.9, which aims to ensure universal access to legal forms of identification. Without some form of identification, it can be challenging to access institutions and opportunities that many of us take for granted, such as healthcare, social protection, education and finance (White et al., 2019). This opens doors for versatile innovation and greater financial access worldwide. However, there are also potential risks associated with the use of Fintech, including surveillance, data breaches, biased decision-making and other ethical concerns (Aitken et al., 2020).

Consequently, in a rapidly evolving Fintech landscape, ethical considerations have emerged as a crucial aspect that demands our attention. As Fintech innovations reshape the way we transact, invest, and manage our finances, evaluating the ethical implications surrounding trust, proximity, accountability, security, privacy and the technocultural gap becomes imperative. By exploring these dimensions, we can understand the ethical implications of the Fintech ecosystem and its impact on fostering responsible innovations for the welfare of individuals, communities, and society at large.

The aim of this article is to determine how these dimensions influence the potential of Fintech and artificial intelligence (AI) development, as well as university-industry collaboration in the context of Fintech. By analyzing the ethical repercussions of the Fintech phenomenon, we can gain a comprehensive understanding of its impact in both the financial and socio-economic spheres. We will consider the opportunities, potential risks, and challenges of regulation, innovation, and business-academia cooperation in the Fintech landscape. Additionally, we will propose best practices that can contribute to a more ethical financial innovation ecosystem.

This article is structured as follows. The next section presents the relevant key ethical principles in the Fintech landscape, followed by an examination of ethics in AI-enabled Fintech. Section 3 focuses on university-industry Fintech collaboration. Finally, our conclusions will be presented in the last section.

Ethical Principles Influencing the Fintech Landscape

Technological advances, particularly in Fintech, are already influencing our lives and have the potential to become integral to various aspects of our existence. It is therefore extremely important to critically consider the impact of new technologies as they emerge, rather than when it is too late or too difficult to mitigate negative aspects of the technology that were not initially considered. In the following sections we will focus on the implications of key ethical dimensions in advances in Fintech.

Trust regarding Fintech

Fintech has deployed globally, but the use of Fintech services is still uncertain, since trust is a key factor in the adoption of new and innovative technologies, and even more so if they have an associated financial component (Fernando & Touriano, 2018). In this context, the information we have about this phenomenon is limited, so confidence in financial technology is subjective.

Previous studies have examined the process of trust transfer to better understand the development

of Fintech. According to Stewart (1999), based on the trust transfer theory, trust can be transferred from an individual to an entity through communicative and cognitive processes. Thus trust transfer is a means of establishing initial trust in unknown organizations doing business online. Consequently, trust can also be transferred in different contexts. For instance, offline institutional trust can be transferred to online and mobile channels in banking operations (Kang et al., 2011).

In the contemporary digital era, trust stands as the cornerstone of financial systems. Unfortunately, it has increasing been eroded in recent decades and it is therefore imperative to understand that without a certain level of trust, the entire economic system could disintegrate (Boatright, 2011). Fintech companies need to bear this in mind and ensure that their innovations obtain the highest possible level of societal trust.

As Klaus Schwab (2016), founder of the World Economic Forum, said: “In a world where nothing is constant anymore, trust becomes one of the most valuable attributes. Trust can only be earned and maintained if decision makers are embedded within a community and taking decisions always in the common interest and not in pursuit of individual objectives.”(p.102). Therefore, Fintech companies need to ensure that the tools they build are trustworthy and secure, and that their business models do not abuse customer relationships by lacking security protocols, selling unauthorized data, or engaging in other inappropriate and unethical practices.

Proximity of Fintech

Proximity refers to the psychological or emotional closeness that decision-makers feel towards those affected by their decisions (Gillani et al., 2021; Wildermuth et al., 2017). This alludes to the notion of how connected an action is to its outcome. Thus, the more proximate a situation is, the more emotionally connected we are to it and the more likely we are to choose to act ethically.

Accordingly, in the case of Fintech, this could encompass different scenarios where apparently its application leads to a greater inclusiveness and closeness in terms of financial services, especially for the unbanked or underbanked (Gabor & Brooks, 2017). On the other hand, Fintech innovators are often so distant or unapproachable to users that they cannot empathize with their privacy concerns. As users, however, we so often accept the terms and conditions of Fintechs that we have become desensitized and do not really think through or question the possible future implications.

Accountability of Fintech

Accountability generally refers to the responsibility and obligation of

individuals, organizations or systems to answer for their actions, decisions and resulting consequences, positive or negative (Mande, 2021). It encompasses transparency, integrity and the willingness to accept the consequences of one's actions (Herzog, 2019).

In Fintech, accountability can be understood in line with trust. From an ethical perspective, when we entrust something into someone's care, there is a certain level of responsibility to protect it. However, when we consent to share our data with third parties by virtue of using their platforms, they can use it as if they own it, but may not have the same responsibility to protect it. This represents a broader approach to data ownership and inherent responsibility, as it is linked to the idea of protection. Consequently, figuring out who is liable in the face of an adverse effect is really complicated and often leaves us walking a thin line.

In this regard, blockchain's anonymity provides greater protection for user data and privacy, at least within the system (Eyal, 2017). However, stolen personal customer data is also bought and sold on blockchain-based marketplaces, as law enforcement often struggles to identify the parties involved (Dierksmeier & Seele, 2018). Similarly, blockchain technology appears to facilitate illegal transactions without intermediaries who can be held personally liable for such transactions, which could leave investors, and even the public at large, vulnerable (for example, due to the unaccountable structure of initial coin offerings).

Cryptocurrencies such as Bitcoin and Monero rely heavily on the aforementioned anonymity, leading to their adoption not only by many individuals, but also increasingly by governments that seek to circumvent transactions in the international financial system because they are subject to various restrictions on access to financial markets or linked to sensitive political issues on a global scale (Arner et al., 2017; Fosso Wamba et al., 2020). This phenomenon denotes a clear transformation of moral foundations, as the founders of cryptocurrencies (particularly Bitcoin) created these currencies in the first place based on moral principles – namely, the idea of decentralizing the market and democratizing finance by allowing people to bypass governments and existing forms of currency. Yet it is interesting to observe how what was initially perceived at least to some extent as a moral imperative is now being used in ways that may not have been originally envisaged.

Security and Privacy when using Fintech

Despite being commonly associated with cryptocurrencies, blockchain technology has broader applications, particularly in terms of identity management. By leveraging the security and integrity of the

stored information, blockchain can serve as a digital identity solution, enabling migrants and refugees without legal identification to access healthcare services (Fosso Wamba et al., 2020). This not only promotes inclusion but also provides avenues for financial access and empowerment.

As Fintech continues to expand, delivering financial services through mobile devices to underserved populations, the importance of cybersecurity and data protection gains significance (Aitken et al., 2020; Ryu, 2018). The growing user base, including individuals with limited technological literacy, raises concerns about their susceptibility to hacking and cyber threats. It is crucial to acknowledge that cybersecurity and cyber regulations are often reactive, making it challenging to establish comprehensive rules that encompass all potential risks.

The susceptibility of Fintech companies to cybercriminal activities is evident from incidents like the Mt. Gox crypto exchange hack in 2014, which resulted in substantial financial losses and bankruptcy (Abramova & Böhme, 2016). Such incidents highlight the urgent need for enhanced security measures to safeguard sensitive financial data. While there is a perception that "crypto" technologies are more secure, there is also a rising concern about potential tracking through technological devices. Instances of fraud and hacking not only lead to financial losses but also compromise individuals' privacy rights (Ryu, 2018), creating a paradoxical situation where the efficiency and convenience of Fintech innovations clash with the need for privacy and security.

While personal privacy and data ownership are highly valued, it is essential to consider the broader implications, such as national security and protection. Instances of significant breaches or hacks that compromise sensitive data or financial resources may necessitate government intervention, even if it potentially infringes on personal privacy rights – for example, through decrypting technological devices (Ng & Kwok, 2017). In this context, individuals who prioritize their own privacy and security may also acknowledge the necessity of certain measures to safeguard society. Thus, this dilemma requires us to navigate the delicate balance between preserving personal privacy and ensuring the welfare of the broader community.

Fintech's Technocultural Gap

There are different types of culture that change at different speeds. In the case of Fintech, this disparity or disconnect can occur between technological advances and the culture or society into which they are introduced (Abbasi et al., 2021). This can lead to potential differences in attitudes, understanding and adoption of technology between different groups and generations

(Ryu, 2018). In other words, this concept alludes to the importance of considering cultural, social and human factors as well as the pace at which technology advances.

Furthermore, it can manifest itself in various ways and may involve a lack of technological literacy or resistance to adopting new technologies among certain individuals or communities. For instance, older people in China may encounter difficulties with using Fintech to make financial transactions (Huang, 2020).

In this sense, this gap often gives rise to significant social problems, misunderstandings, and conflicts. For instance, smartphones were adopted almost overnight, but it took almost a decade for people to realize their negative impact on their lives.

Despite the challenges posed by this gap, the example of Canada can be seen as an example of reinvention and creativity, where blockchain mining operations, while contributing to noise pollution and high electricity consumption, are also repurposing idle logging facilities and creating employment opportunities. Additionally, innovative approaches are emerging to use the heat generated by mining equipment to heat industrial complexes and other buildings (Fowler, 2022). This means that the impact of these Fintech innovations on the natural environment is mixed-purpose, as culture catches up with technology, and at the same time is broader than person-to-person transaction costs or access to finance.

In this context, the Figure 1 illustrates the overall dynamics of the key ethical principles influencing the promotion of ethical Fintech innovation.

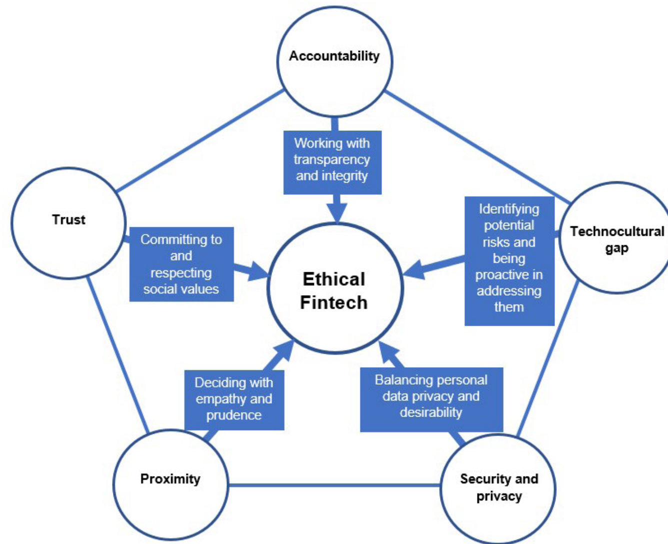
Ethics in AI-Enabled Fintech

Artificial Intelligence (AI), an umbrella term for various technologies, involves creating intelligent machines (McCarthy, 1981). With advances in computing power and data analysis, AI's capabilities continue to improve. This progress has contributed to the growth of AI-enabled Fintech, with machine learning playing a significant role. Algorithmic trading, risk management, fraud detection, and operational optimization in financial institutions are all benefiting from machine learning's efficiency and accuracy (Max et al., 2021). These applications rely on vast amounts of data, which serve as the fuel driving AI-enabled Fintech innovation.

A Matter of Trust

Regarding the issue of trust, many AI innovations are increasingly permeating the financial ecosystem while we, as humans, tend not to trust things we do not understand about technology and especially how it works. Instead, we tend to trust our own ability more than we probably should. As a result, we are

Figure 1. Ethical Fintech



Source: Author's work

resistant to change, continually over-trusting ourselves and under-trusting technology.

AI relies on training algorithms to recognize patterns through extensive data input, refining and repeating the process to achieve success. However, this training process introduces the potential for human error and bias. If the data used already contains discriminatory or cultural bias such as the developer's bias, the resulting algorithms will inevitably be biased (Turner Lee, 2018). Algorithms are thus not as neutral as many people have come to expect, presenting a challenge for lawyers, technologists and ethicists, not only in terms of programming, but also in creating a moral code for employees of AI technology companies that transcend national borders and whose products and services increasingly permeate societies. However, this challenge must be addressed prudently, because what is appropriate in one cultural context may be questionable in another, illustrating the importance of ethical relativism across cultures.

Distributional Conflicts

The international nature of the financial industry and its pivotal role in the economy make it vulnerable to systemic consequences, as seen in the 2008 financial crisis. In today's technological landscape, even individual unethical behavior can disrupt the financial system – for example, through hackers exploiting AI decision-making

patterns. Thus, AI failures may have wider implications beyond personal relationships, encompassing considerations of the common good.

Similarly, the welfare state, built on the principles of solidarity and economic contributions to assist the disadvantaged, may encounter challenges in the realm of insurance due to the precise assessment of individual risk profiles enabled by AI algorithms (Hagendorff, 2020). This scenario gives rise to ethical and equity concerns that can impact willingness to provide financial support to others. Individuals with a lower risk profile may exhibit less willingness to contribute to those with a higher risk profile if they have the option to opt out. This can lead to heightened distributional conflicts and ethical questions about who should bear the financial burden such as whether the healthy should pay for the unhealthy and the rich pay for the poor.

Reductionism and Fairness

The fairness debate lies at the core of AI-Fintech ethics, as biases and injustices in AI models can reinforce each other (O'Neil, 2016). Therefore, it is crucial for financial firms to assess their datasets thoroughly because they may contain historical biases stemming from different social norms. Financial firms should also take care when designing algorithms to avoid discriminatory outcomes. Otherwise, seemingly efficient AI systems may categorize or quantify people's characteristics in ways that lead to dehumanization and marginalization.

The issue of AI bias becomes more problematic in black-box algorithms which lack transparency and can cause harmful effects at scale (O'Neil, 2016). Additionally, private companies are often reluctant to allow scrutiny of their practices. This raises the question: How can we create inclusive algorithms when the data, developers, and organizations lack diversity and inclusivity? While algorithms are valuable tools, they do not always align with our ideals of fairness.

This phenomenon brings us back to the question of trust. We are aware that biases present in data and resulting models are influenced by human nature and carry value judgments (Argandoña, 2021), implying that we do not have a flawless track record. However, we may be entering an area of complete amorality, built upon existing historical data, which could introduce new biases or further entrench existing biases in decision-making processes. Thus, we face a dilemma: Which should we trust more - the inherent human biases in existing systems or the potential biases in AI datasets that will emerge in the future?

Improving AI and Proximity Challenges through greater accountability

Establishing trust in AI is a complex undertaking that requires organizations to develop reliable systems with transparent, explainable,

and reproducible models (Morley et al., 2019), especially given its potential impact on people's financial well-being. In this context, the interpretability and transparency of AI models are key factors in ensuring ethical accountability, as they allow users and stakeholders to understand the decision-making process behind AI-driven outcomes. Furthermore, these aspects enable responsible entities to be held accountable for the deployment and management of AI algorithms.

Human oversight and accountability are essential in Fintech when AI algorithms are involved in decision-making. This requires establishing ethical guidelines, conducting regular audits, monitoring algorithmic performance, and intervening when necessary to identify and rectify biases and prevent discriminatory results (Hagendorff, 2020; Turner Lee, 2018). For example, an AI-driven loan application system should not unfairly reject applicants based on factors such as their home address or minority status.

Primarily, accountability should be assigned to specific agents such as programmers and data scientists. However, given the multitude of actors involved in AI outcomes, a comprehensive approach that fosters a shared corporate culture of accountability is necessary. Organizations should also strike a balance between their decision-making authority and what they delegate to AI (Burr et al., 2020), in line with their values, legal requirements, and ethical standards. Moreover, empowering users and providing accessible mechanisms for dispute resolution and addressing user complaints are essential components of accountability.

This last aspect is paramount in terms of proximity, as it implies an inherent sense of accountability to those affected. Coeckelbergh (2016) argues that the use of technology in financial markets can create moral distancing and detachment between users of technology and the individuals and communities impacted by financial decisions. This detachment can be exacerbated when AI technology serves as an intermediary, diminishing the sense of moral responsibility. Additionally, when the affected individuals are geographically distant from financial markets and unknown to AI designers, the moral obligations further weaken. Consequently, unless AI systems are purposefully designed to prioritize empathy and closeness, these complex technologies may contribute to a state of moral invisibility, making it challenging to establish a genuine sense of proximity and moral responsibility towards those affected by financial decisions.

Deontological and Utilitarian Perspectives on Security and Privacy

In AI-enabled Fintech, security and privacy raise ethical considerations from both a

deontological and utilitarian perspective. Deontologically, protecting security and privacy is viewed as a moral duty and individual right, respecting autonomy and valuing privacy (Anshari et al., 2021). AI has an ethical obligation to implement robust security measures and safeguard personal information, even if it may not always directly benefit customers, as seen in peer-to-peer (P2P) lending companies (Thakor, 2020).

The overall consequences and benefits of data usage in AI-enabled Fintech can also be evaluated from a utilitarian standpoint. Advocates of utilitarianism argue that extensive data collection and analysis can lead to improved financial services, personalized experiences, and increased efficiency, benefiting individuals and society (Max et al., 2021). However, we must critically assess the potential risks and harms associated with data breaches, unauthorized access, and misuse of personal information. Striking a balance between potential benefits and potential negative consequences is crucial to ensure the greatest good for the greatest number of people.

The Technocultural Gap in Legislation and the Need for Ethical Intermediaries

In the context of AI-enabled Fintech, ethics and law may not always align. The rapid development of technology presents challenges in assessing its impact and anticipating unforeseen outcomes, despite the increased adoption of technical and deontological measures such as stricter norms and regulations and more codes of conduct following the financial crisis. This can result in situations where certain actions are technically legal but may be considered unethical, and it becomes difficult for the law to proactively address all potential issues and stay ahead of unethical behavior.

The speed of AI progress can further exacerbate digital divides, particularly for communities with limited technological access and expertise. This means that the introduction of AI may bring about significant uncertainty in various domains. Expanding knowledge about AI technology can help reduce this uncertainty and is a moral imperative that all stakeholders should actively pursue, as highlighted by Svetlova (2022). However, it is important to acknowledge the inherent complexities and limitations in understanding and controlling AI systems, including the development of explainable AI and gaining a deeper comprehension of collective machine behavior.

Relying solely on legislation and government regulation may not be sufficient to control and regulate AI phenomena effectively. A broader approach is necessary which recognizes the systemic nature of AI-induced risks and critically considers the distribution of benefits and harms associated with AI technologies. Instead of focusing

solely on individual components, this approach should emphasize the relationships within the AI-enabled financial ecosystem.

In this regard, a necessary step at a systemic level could involve the establishment of an ethical intermediary such as professional associations or system-wide intelligence hubs. These entities would play an integral part in promoting professional ethics, education, and moral debate. During industry-wide digital transformations, they could act as think tanks or arbiters, addressing AI ethics, providing expertise in understanding and managing systemic impacts, proactively defining zones of uncertainty and facilitating multi-stakeholder consultations to clarify core values and tensions.

University-Industry Fintech Collaboration

Fintech innovation presents challenges that necessitate a broad conversation involving various stakeholders. Siloed discussions among big businesses, the public sector, and users will not lead to sustainable market outcomes that consider all perspectives. To comprehend the implications of these challenges, comprehensive education is crucial. It should focus on critical discernment and reflection regarding financial complexities, fundamental human questions, and the ethical and responsible use of technology. Universities, as knowledge hubs and collaborative platforms, can play a vital role in fostering this education and promoting cooperation among stakeholders, driving ethical progress.

Furthermore, universities, as public institutions, have a third mission: to contribute meaningfully to society by creating and sharing knowledge and technology. This mission has led to an increasing need for closer collaboration with industry in order to build an innovation system and support the potential economic growth and welfare of the region and country.

Joint Efforts Are Needed

In the context of Fintech innovation, collaboration between universities and industries is becoming increasingly central. Such interactions contribute to the development of innovative financial firms in both developed and developing countries (Laidroo & Avarmaa, 2020). The demand for Fintech talent further underscores the necessity of collaboration to safeguard talent within the Fintech ecosystem (Mei et al., 2018). Government involvement is also crucial in fostering Fintech companies, particularly in emerging economies, and facilitating effective communication between academia and businesses (Galan-Muros & Davey, 2019).

However, conflicts often arise between the profit-oriented goals of industry and the knowledge dissemination and educational aims of universities. The latter are of instrumental value to industry, but

Table 1. University-Industry Fintech Collaboration Based on Ethical Principles

Ethical Dimensions	Implementable University-Industry Actions
Building Trust	Trust is vital for successful university-industry collaboration. It relies on transparency, open communication, and shared ethical values. Embracing open innovation facilitates collective intelligence by openly sharing knowledge and expertise, nurturing trust, and fostering a collaborative environment (de Wit-de Vries et al., 2019).
Accountability and Responsible Innovation	Ethical accountability is crucial for prioritizing user and societal welfare in financial innovations. Industry and academia must consider social impacts, adhere to legal frameworks, and address risks in developing Fintech solutions. According to Stahl (2022), this requires aligning responsible innovation with societal needs and engaging stakeholders to harness collective intelligence. Integrating risk anticipation, stakeholder deliberation, and ethical principles into research and innovation processes enables active influence on the trajectory of innovation while ensuring risk prevention, research integrity and ethical compliance.
Security and Privacy	In the era of Fintech, ensuring robust security measures and protecting user privacy are ethical imperatives. University-industry cooperation should prioritize data protection and implement privacy-enhancing technologies.
Proximity	Close collaboration and proximity between universities and industry enhance mutual understanding and drive effective development of Fintech solutions for real-world challenges. Bridging the gap between academic research and practical implementation is crucial to ensure relevant, usable, and ethically aligned solutions.
Bridging the Technocultural Gap	Bridging this gap necessitates interdisciplinary collaboration and a deep understanding of societal implications. University-industry cooperation should embrace diverse perspectives, incorporating insights from social sciences, humanities, and ethics.

Source: Author's work

of intrinsic value to universities. Similarly, publicly funded universities face the dilemma of sharing knowledge with industry partners while fulfilling their obligations to the public. These misalignments in value priorities highlight the need for a broader and more empathetic approach to promoting ethical financial innovation in the interests of society at large.

Successful university-industry cooperation requires institutional, strategic, and structured collaboration driven by ethical considerations and mutual trust. It involves adopting the role of the other and embracing a Kantian approach of reciprocity which is often rendered as "do unto others as you would have them do unto you". This approach entails creating a shared vision of desired transformations, devoid of selfish attitudes or interests, that incorporate purposeful actions for the common good. This collaborative model transcends the traditional knowledge flow from universities to businesses and emphasizes the importance of multiple links, flows, and backflows between partners.

In this spirit, ethical financial innovation necessitates a consensus space for proactive collaboration among stakeholders across different disciplines, cultures, and regions, with a particular emphasis on incorporating the voices of marginalized communities directly affected by tech development. Genuine, effective cooperation should therefore be inclusive, generating synergies not only for financial benefits, but also for a deeper commitment to the development of ethical values.

In this regard, Table 1 suggests possible actions that can pave the way for a better university-industry relationship with respect to five key ethical principles.

We outline the dynamic interactions and interventions that could be utilized to promote more ethical financial innovation in Figure 2, taking into account the previous discussion.

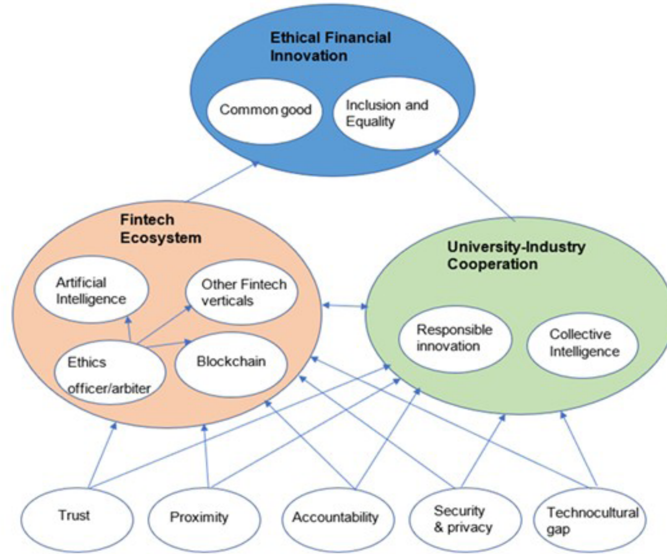
These suggestions for interventions are broad, but they can be translated into concrete policy proposals or organizational practices if there is a common will to promote mutual trust and cooperation between the various parties.

Conclusion

The ethical dimensions surrounding trust, proximity, accountability, security, privacy and the technocultural gap play a significant role in shaping the potential of Fintech and its impact on society. The Fintech ecosystem must prioritize building and maintaining trust by ensuring that its innovations are trustworthy, accountable, promote proximity between innovators and communities, and are secure and insightful enough to bridge the challenging technocultural gaps.

Trust is fundamental not only in the adoption of Fintech services

Figure 2. University-Industry Fintech Collaboration Based on Ethical Principles



Source: Author's work

but also in fostering meaningful collaboration between stakeholders, particularly for achieving a beneficial equilibrium within university-industry partnerships. This equilibrium is vital for promoting ethical and responsible innovation. In cases where AI is involved, there should be a shift from a design-for culture to a design-with-and-by culture, with a specific focus on vulnerable communities. By nurturing trust and inclusivity, Fintech can create an environment where all participants work together for the common good, ensuring that innovation is driven by shared values.

Proximity is another critical ethical consideration in Fintech. The aim should be to provide inclusive financial services, address the digital divide, and empower users with the necessary tools and knowledge to participate in the Fintech revolution. This also implies the need for greater technological literacy on the part of affected communities and stakeholders. In essence, it is only fair if proximity fosters a sense of empathy in Fintech innovators, allowing for the cultivation of greater social understanding of these communities and their diverse contexts.

Accountability is essential in Fintech to maintain consumer trust and ensure responsible conduct. Fintech companies should uphold transparency and integrity, particularly in the use of AI models, where explainability

and delegation are crucial. In this sense, rather than prioritizing rapid iterations, it is important to sacrifice a little efficiency to make AI fairer, aligning it with pluralistic human values. It is prudent to preserve the human element in the process to verify if everything is resolved or interpreted correctly, thus ensuring accountability and ethical behavior.

In Fintech, security and privacy hold paramount importance due to the extensive amount of personal data involved. Fintech companies bear an ethical responsibility to implement robust security measures and safeguard personal information. However, finding the right balance between convenience and data protection poses a significant ethical challenge. To bridge the technocultural gap and effectively understand and control the Fintech ecosystem, the establishment of ethical intermediaries becomes crucial. These intermediaries can facilitate ethical discussions, provide expertise, and address AI ethics in the industry, compensating for the retrospective nature of regulations and ensuring a proactive ethical approach.

In short, by incorporating ethical considerations into the development and deployment of Fintech, we can create a more responsible and inclusive financial ecosystem. This will prioritize the welfare of individuals, communities, and society as a whole. Fintech has the potential to become a purpose-driven catalyst for innovation, harnessing technology for the common good while mitigating risks.•

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Part III

Shades of Green : Sustainability in Finance

Justice and Sustainability : Pricing in Physical Climate Risks

Ethics & Trust in Finance
Global edition 2020-2021

First Prize

Julie Segal
Canada
Senior Analyst, Impact Investing, The McConnell Foundation, Montreal (Canada)*

* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

Pricing in climate risk brings risks of its own

Pricing in climate risk is a recent approach in the movement towards sustainable finance. Under this approach, investors integrate climate change-related risks to determine the financial terms for an investment. Investors may choose to exclude investments with high climate risks from their portfolios. In doing so, investors aim to mitigate their exposure to climate change. But in the absence of controlling measures, pricing in the physical risks from climate change creates an asymmetric cost of capital dependent on regional vulnerability. Pricing in physical climate risk is inconsistent with distributive environmental justice. It also aggravates the climate and social issues that sustainable finance aims to confront. However, sustainable finance can integrate environmental justice to bring integrity to private financial markets.

Investors consider three types of climate-related risk: those related to the physical impacts of climate change; the transition of social preference; and changing regulation. This paper focuses on physical climate risks. I consider environmental justice based on the distribution of risks and rewards from natural resources. My analysis draws on a 2018 study commissioned by the United Nations Environment Programme (UNEP) which demonstrates that countries facing climate risk are charged more for debt capital (Buhr & Volz, 2018). I extend this analysis to explain that a risk-based approach to climate finance consistently disadvantages vulnerable countries

and communities. Drawing on the principle of double materiality, I outline why this phenomenon is concerning for investors. I then evaluate academic definitions of environmental justice, highlighting that environmental justice guides international and national climate policy yet is ignored in private finance. I examine case studies to conclude how sustainable investors can learn from these frameworks. To enable equitable access to investment capital for global climate resilience, environmental justice and non-market measures should complement financial decision-making principles. Otherwise, pricing in climate risk could obstruct climate action by aggravating geographical and historical inequities.

Why is this important? Countries and communities – particularly less wealthy, industrializing ones – rely on international credit markets for domestic investments. In recent years, for example, lower-income countries accrued over $380 bn annually in external debt (World Bank, 2021). Vulnerable regions cannot unilaterally escape this system of international finance (Singer, 2004). Researchers debate whether international investment capital is good for development. I accept that it is a pragmatic necessity in a globalised financial system. Countries need this investment capital to build resilience to climate risks. However, when investors prioritise their own returns, high costs of capital can impede investments into climate adaptation and mitigation (Miller & Picolotti, 2020; Mirza, 2003). This undermines global cooperation against climate change, reveals a vital gap in the movement towards sustainable finance, and furthermore, creates risk for the financial system (Coburn et al., 2015; Nieto, 2019; Quigley, 2020; Roncoroni et al., 2021). To foster global climate resilience, investment capital must be allocated according to principles of environmental justice and not only according to market dynamics.

Climate change risks determine borrowing costs

Traditional financial principles dictate a higher financial return for higher risk investments. When investors confront risk, they either decline to make an investment or demand a higher return as compensation. In 2018, UNEP commissioned SOAS University of London and Imperial College Business School to examine how this principle relates to climate change. The authors analysed the cost of capital for the 48 countries most vulnerable to the physical risks of climate change, as identified by the *Vulnerable Twenty (V20) Group* . Through econometric analysis, the authors confirmed that financial markets are pricing in physical, social, and economic climate risks. These slowly unfolding climate trends quickly affect the cost of capital. As a result, countries most susceptible to climate damage are

experiencing increasingly higher borrowing costs. As of 2018, "climate vulnerability has already raised the average cost of debt in a sample of developing countries by 117 basis points" (Buhr & Volz, 2018, p. iv). These countries have spent over USD $62 bn in additional interest payments over the past 10 years (Buhr & Volz, 2018, p. 11). Previous literature explains the economic cost of natural disasters, but the connection between climate change and sovereign risk is new (Cevik & Jalles, 2020; Mallucci, 2020).

Credit rating agencies dictate a country's credit score, and therefore, influence their cost of capital in international markets. Rating agencies have not yet downgraded any country explicitly because of climate change risk. However, their rating systems are capturing climate-related factors. In 2014, Standard & Poor (Kraemer & Negrila, 2014) recognised that climate change would:

"impact sovereign creditworthiness, in most cases negatively […] with poorer and lower rated sovereigns typically hit hardest, which could contribute to rising global rating inequality (p. 2)…The degree to which individual countries and societies are going to be affected by warming and changing weather patterns depends largely on actions undertaken by other, often far-away societies" (p. 3).

In other words, the rating agencies recognize that pricing in climate risk affects countries unevenly. They appreciate that this distribution contradicts historical responsibilities for causing climate change. Yet rating agencies continue to price climate risks into credit ratings without critically evaluating the impact of their decisions.

Vulnerable Regions are Financially Penalized for Global Climate Risks

Buhr & Volz focus on borrowing costs for developing countries. As discussed throughout this paper, debt and insurance show similar cost patterns: the most vulnerable are financially penalised for climate risks (Segal, 2020). Early research suggests that the price-effect of climate risk is less pronounced in other areas, such as equity financing for private firms (Kling et al., 2021). But the impact is significant for vulnerable countries and communities (Cevik & Jalles, 2020; Glass et al., 2015; Mallucci, 2020; Neslen, 2019). Private investment – through sovereign borrowing, personal insurance, and local project finance – can shape the prosperity of a region. These financial flows stimulate development, affecting human rights and influencing financial markets.

The 2018 study published by Buhr & Volz recognises that physical climate risk is "asymmetrical" (p. 3). However, the report does not apply an equity framework to these findings. The authors propose that a country can invest in climate adaptation to mitigate the higher

cost of capital. This is sound advice. But place-based adaptation projects cannot completely counteract climate vulnerability or the related investment penalty (Mirza, 2003). This is particularly true for low-lying countries at risk of devastation, such as Tuvalu or the Marshall Islands. These countries are trapped in a feedback loop of increasing capital costs, vulnerability to climate risks, and eventual capital flight. As more asset owners and managers evaluate climate risks in their portfolios, the cost of capital for vulnerable countries will only increase. Global cooperation to limit global warming is the best way to allay these regional consequences (Klusak et al., 2021).

Informed investment decisions should include climate-related data. Investors and academics maintain that better environmental, social and governance (ESG) data is important – which it is (Busch et al., 2016; Orlitzky, 2013). Complete and reliable information about costs and benefits optimises social cooperation (Ostrom, 2010). Furthermore, accounting for transition and regulatory risk can expose stranded assets, which are environmentally unsustainable and eventually unprofitable (Caldecott, 2017). Pricing in these risks can shift capital out of high-emitting industries. However, by pricing in the physical risks of climate change without accounting for principles of environmental justice, the regions most vulnerable to climate change are charged for a global problem. This creates a degenerative feedback loop. If vulnerable countries cannot afford to invest in adaptation, their climate risk (and cost of capital) is only compounded. If they cannot invest in mitigation, global efforts to reduce carbon emissions are weakened.

Pricing in climate risk is a tenet of sustainable finance and responsible investing. But it does not create a satisfactory outcome for all stakeholders. It does not create an ethical outcome either. S&P's blithe statements illustrate how private finance resists amending traditional models to account for equity considerations. Full information is important, but pricing in the physical risks of climate change financially burdens vulnerable communities, subverting international equity.

Examining frameworks for environmental justice

Less wealthy countries face the greatest physical and financial damage from climate change (Abeygunawardena et al., 2002; United Nations Development Programme, 2011). Yet these countries are least responsible for the offending environmental degradation and greenhouse gas emissions. Philosophers generally agree this is inequitable. Wealthier industrialised countries should be the highest contributors to mitigation and adaptation (Gardiner, 2004, pp. 578-583). Environmental justice mandates that the burdens of climate change should be paid by

those historically responsible and by those with the capacity to pay (Shue, 1999, 2014; Singer, 2004). The "offending" countries have a moral obligation to "shoulder the burden" by supporting the less affluent and more vulnerable ones (Shue, 1999, p. 534). These maxims are integrated into international climate negotiations and national climate efforts.

The UN Framework Convention on Climate Change (UNFCCC), for example, considers environmental justice through the principle of common but differentiated responsibility. This principle has guided the UNFCCC for nearly thirty years since the United Nations Conference on Environment and Development (UNCED) in 1992. It ratifies countries' differing contributions to, and ability to address, climate change. All state actors are responsible for addressing climate change but they are not equally responsible. Although the principle remains contested in practice, leaders across the political spectrum appreciate the logic behind it.

Common but differentiated responsibility is applied to climate finance through a binding clause in the Paris Agreement. As proposed by Singer and Shue, the less industrialised countries should expect financial support from those with a greater historical responsibility for climate change. Wealthier countries contribute capital through pooled mechanisms such as the Global Environment Facility and Green Climate Fund. This funding enables vulnerable and less affluent countries to decrease their emissions and achieve climate resilience. The Paris Agreement further encourages wealthy countries to mobilise "climate finance from a wide variety of sources, instruments and channels" (United Nations Framework Convention on Climate Change, 2015, Article 9). While mobilisation has been insufficient, the intention to align international finance with environmental justice is clear.

Similarly, in the local context, environmental risks are distributed unequally by race and class (Agyeman et al., 2009; Bullard, 1993). To counter this, environmental justice analyses are increasingly applied in public economics. For example, countries carefully regulate carbon prices to avoid disadvantaging low-income households. A recent decision by the Supreme Court of Canada reveals how environmental justice shapes national economics. In this case, Canadian provinces contended that a carbon price was within their jurisdictional remit. Three of the ten provinces attempted to avoid a carbon price by using this argument. However, the Court mandated that national carbon pricing is essential to mitigate climate change (*References re Greenhouse Gas Pollution Pricing Act*, 2021 SCC 11 at paras. 12, 46, 187, 206). The Court's decision noted that the harm from climate change would be "borne

disproportionately by vulnerable communities" (ibid., at para. 206). This example is particularly apt because the Court evaluated climate action and environmental justice as a reason to override historical power dynamics. Legal decisions often express social values and demonstrate a tipping point for new norms (Cooter, 1998). This decision is therefore encouraging for similar calls internationally. Activists and academics who are motivated by environmental justice propose that revenues from global carbon taxes should be partially distributed to vulnerable people living in poverty (Soergel et al., 2021).

Aligning Finance with Environmental Justice

Supporting vulnerable countries and communities can promote cooperative climate action. These examples can be a foundation for integrating environmental justice into finance. They provide three clear lessons. First, public bodies increasingly accept that environmental justice should guide climate action. Second, equitable climate action requires collective and cooperative solutions. And third, historical approaches and power dynamics should sometimes yield to environmental justice priorities.

However, finance is one of the few areas that has not aligned with the goals of environmental justice. Based on the logic employed by the UNFCCC and the Supreme Court of Canada (among others), pricing in climate risk is regressive. By trying to mitigate the risks from climate change to individual portfolios, vulnerable countries and communities are overcharged. The financial institutions which benefit from these semi-protected portfolios are in part historically responsible for climate damages, having funded extractive and emitting industries in the decades before the Paris Agreement and the five-years since (Rainforest Action Network, 2021). Purely market-based approaches are not designed to address this inequity, despite the best efforts of the sustainable finance movement.

Rather, the financial system needs new rules, institutions, and governance practices to complement the market fundamentals of risk and reward (Dunlop & Usher, 2020, p.3). These frameworks must make environmental justice explicit. The wealthier industrialised countries created the traditional framework for risk, reward, and cost of capital. This system is structured to maximize efficiency and profit, not equity. Duties of global equity must delimit financial profitability to reconcile private finance with international climate cooperation.

Environmental justice is essential for a stable financial system

As outlined, investors increasingly consider how their investments are affected by climate change (Busch et al., 2016; Sautner et al., 2020; Scott et al., 2017; Weber,

2012). Many investors also claim to consider how their investments affect climate and society (Esty & Karpilow, 2019; Unruh et al., 2016). Both factors influence long-term financial performance (Clark et al., 2014; Coburn et al., 2015; European Parliament, 2021; Quigley, 2020; Täger, 2021). Yet it is important to distinguish between these two approaches. Pricing in climate risk is part of sustainable finance. However, mitigating the climate risk in a portfolio may not generate sustainable climate outcomes (Busch et al., 2016; Caldecott, 2020a; Caldecott, 2020b), and certainly does not align with environmental justice.

Investors would be wise to focus on generating positive climate outcomes. To achieve meaningful progress, this should include both environmental and equity considerations. Climate risks will compound existing inequalities by disproportionately affecting less wealthy countries and communities (Abeygunawardena et al., 2002; Cevik & Jalles, 2020; Howard & Sylvan, 2021). But climate change is a collective challenge. There are global consequences if vulnerable countries cannot access capital for climate mitigation and adaptation. Although climate change will intensify inequality between high- and low-income countries, 78 per cent of a recent survey of climate economists believe climate change will damage the economy internationally (Howard & Sylvan, 2021). Consider that carbon reduction and biodiversity protection (two key mitigants for climate change) require global cooperation. We share a global carbon budget, meaning that we must reduce cumulative emissions rather than offset emissions to another location (Caldecott, 2020a). Macroeconomic systems are similarly interdependent, demonstrated by historical financial crises spreading between countries (Frankell, 2000).

Investors should therefore mitigate risks in the market as a whole (Quigley, 2020). Instead of trying to externalise risk, investors can reduce risks across their portfolio by advancing climate action and redressing social inequity. Financial supervisors have defined new expectations for investors to consider double materiality: both the climate risks to a portfolio and the climate implications of the constituent investments (European Parliament, 2021). This idea of systemic or unhedgeable risk is increasingly relevant across all facets of climate change (Coburn et al., 2015; Principles for Responsible Investment, 2020). Investors can better appreciate these holistic risks by applying a longer-term investment horizon (Barbosa Vargas & Segal, 2021; Busch et al., 2016). With a long-term approach, investors realise that perpetuating climate and social risks will disadvantage their long-term financial performance. Furthermore, they realise that today's investments will shape tomorrow's economy. Double materiality formalises these

two sentiments.

Pricing in climate risk aims to mitigate threats to individual investment portfolios. Yet this tactic compromises global progress against climate change. By weakening aggregate climate action, pricing in climate risk negatively affects the market and the portfolios of individual investors. Sustainable finance purports to advance climate outcomes. However, to be effective, private finance must be held to the same environmental justice frameworks that guide other climate-related decision-making processes. The following section analyses how environmental justice can be integrated into sustainable finance, embedding the principles that sustainable finance aims to espouse.

Models for application

The relationship between climate finance and environmental justice is relevant in international and local contexts. But the dilemma is more complicated at the international level. The increased costs of capital from exposure to climate risk appears most intractable internationally since international cooperation is predicated on voluntary institutions. However, national approaches can be instructive for international solutions. Climate solutions generally require collaboration between private and public finance (Caldecott, 2020a), and may require a shift in the values and mission that guide the private financial sector (Biagini & Miller, 2013). There are ways to integrate climate risk data for combined economic and environmental justice. This section considers new collaborative structures (public-private partnerships), mandatory regulation, and voluntary action. Some proposals would limit the financial penalties for vulnerable regions while others would encourage new investments in climate adaptation.

New Collaborative Structures

The Flood Re model in the United Kingdom is one structure worth examining. The joint not-for-profit effort between the U.K government and the insurance industry creates a pooled mechanism for flood-related home insurance. Although the U.K. has high flood exposure, the risk differs between regions. Under purely market mechanisms, the insurance industry would price these differentiated risks into insurance premiums. Households in high-risk flood zones would face exorbitant policy premiums – and possibly become uninsurable – as risk increases. However, Flood Re's pooled, country-wide mechanism ensures all households are eligible for affordable flood-related home insurance. Households contribute to the pool based on their council tax banding, a proxy for their ability to pay. By aggregating individual interests, this model ensures that high-risk households can access financial mechanisms to support their physical and financial resilience to climate change.

The structure is certainly not without flaws (OECD, n.d.). But it deliberately leverages climate-related data to confront unequal exposure to risk. Flood Re shows key elements for more equitable climate-related capital flows, with its pool and levy system creating a shared response to vulnerability. The progressive levy aligns with the principle of common but differentiated responsibility, acting on the reality that risk distribution does not correspond with the ability to pay. Furthermore, rather than using data in a zero-sum approach that protects private interests, the model leverages climate data for a collective solution. This data-informed approach curtails unequal risk exposure rather than aggravating the imbalance.

The programme's governance structure is the final and most important aspect to consider. Flood Re is an independent not-for-profit organisation. Many consider climate change as "the greatest [...] market failure" of all time (Stern, 2006, p. i), recognising that private finance improperly accounts for society's relationship with nature. This collaborative initiative demonstrates how a publicly oriented structure can mitigate market failure. The U.K. government is equally accountable to all constituents and therefore motivated to pursue an equitable solution. The government's democratic accountability is complemented by the expertise of the insurance industry. This collaborative structure protects vulnerable policyholders instead of prioritising short-term profits. At the same time, it reduces systemic vulnerability in the financial sector.

African Risk Capacity (ARC) pools climate insurance risk across a larger region. ARC provides affordable financing across the African Union to prevent and respond to natural disasters. International institutions could further extend these risk-pooling models globally. Wealthier, industrialised countries could act as donors and insurers for countries that do not have the capacity to respond to local climate damage. Similar collaborative structures can apply to debt investments, too, encouraging new investments in climate mitigation and adaptation. For example, creditors could offer debt-for-climate swaps, foregoing debt repayment and authorising borrowing countries to invest an equivalent amount in projects that advance climate resilience (Miller & Picolotti, 2020). Furthermore, governments could provide partial guarantees on new loans for adaptation and mitigation in vulnerable regions. Many countries already use loan guarantees to promote affordable access to financing, particularly for homeownership. For example, the Canada Mortgage and Housing Corporation is a publicly owned corporation that acts as a guarantor for homebuyers in Canada; Freddie Mac and Fannie May facilitate similar outcomes in the United States. Similar guarantees could

enable affordable interest rates for infrastructure in regions with high climate risks. This would align public and private finance to prioritise environmental justice and systemic resilience over short-term profits.

Regulation

Some factions of private finance may not be amenable to foregoing short-term returns or participating in public-private structures. In these cases, national laws and regulations can supplement collaborative structures. To reduce the debt burden for vulnerable regions, creditors could be mandated to include disaster clauses on new loans. Disaster clauses permit borrowers to suspend principal and interest payments if they experience a natural disaster (International Monetary Fund, 2020; Mallucci, 2020). While postponing payments is beneficial, disaster clauses do not stimulate new capital. To incentivise proactive investments, financial institutions can be mandated to target a certain percentage of assets for projects that build resilience in vulnerable regions. Mandated climate targets are an important tool to align private finance with positive climate outcomes (Caldecott, 2020b). This could take as its model the Community Reinvestment Act in the United States, which encourages financial institutions to provide affordable credit to lower-income members of their communities.

Voluntary Action

The financial sector can, of course, lead with voluntary action. Existing disclosure frameworks could include positive impacts and systemic risks instead of only considering the climate risks in individual portfolios. Integrating the principle of double materiality into the Task Force on Climate-related Financial Disclosures (TCFD) would be a good start (European Parliament, 2021; Täger, 2021). Including reference to the principle of common but differentiated responsibility would make environmental justice considerations explicit. As private finance integrates environmental justice, it should include impacts on the most vulnerable countries internationally as well as considerations for local workers and communities (Robins et al., 2018). These voluntary measures can be powerful, given the increasing importance of climate action for firms' reputations and social licence to operate. However, voluntary action has been insufficient (Ameli et al., 2020). Voluntary measures will be most impactful when paired with collaborative structures and mandatory regulations.

Environmental justice is increasingly recognised as central to climate action. These collaborative structures, mandatory regulations, and voluntary actions can align sustainable finance with international and national policies. Collaborative interventions (through structures like Flood Re, or alternatively,

regulation) can foster stability and equity in ways that financial markets cannot. Mechanisms that prioritise universal affordability are needed at the national and international level. Deliberate policy interventions can use climate data for communal benefit, dissociating the inequitable relationship between financial wealth and climate resilience. This would ensure that the regions needing to invest in climate adaptation are able to afford it.

Conclusion

Private finance views pricing in climate risk as an appropriate, sustainable, and responsible way to integrate the reality of climate change. However, this has an undue negative effect on the most vulnerable countries and communities. Investment decisions should include climate-related data, but they should be guided by principles of global environmental justice instead of short-term profitability. Equitable access to financing can ensure affordable insurance for vulnerable regions and stimulate new investments in climate mitigation and adaptation. Environmental justice is an important consideration for financial institutions that want to align with climate action and the sustainability agenda. Based on the principle of double materiality, it is also critical for reducing systemic portfolio risk.

This paper reflected on frameworks of environmental justice, including the works of Gardiner, Shue, and Singer, and the UNFCCC principle of common but differentiated responsibility. Based on these principles, I argue that market mechanisms should not be left to independently address climate change issues. By examining existing public-private partnerships, potential regulation, and voluntary action, I conclude that hybrid, publicly oriented measures are important to facilitate greater environmental equity within climate-related capital flows. •

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The Ethics of Sustainable Investing

Ethics & Trust in Finance
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Second Prize ex-aequo

Alina Mika
Poland
*Associate Economist, the European Bank for Reconstruction and Development**,
London (United-Kingdom)

* The contents of this essay reflect the views of the author and do not necessarily reflect the views of the EBRD.

The COVID-19 pandemic is expected to accelerate the trend of incorporating sustainability considerations in investing (J.P. Morgan, 2020). This is a remarkable outlook, given the eye-opening growth in such investments in recent years. Already between 2014 and the first quarter of 2020, assets under management of signatories of the Principles of Responsible Investing grew by over 100 per cent (State Street, 2020).

The spectacular growth has, however, led to some concern over the field's ability to deliver on sustainability outcomes. Disquiet has come from both market participants and academic circles; it ranges from the criticism of investors' focus on the bottom-line (Richardson, 2009) to doubts over the validity of ESG metrics (investors surveyed in McKinsey & Company, 2019).

In this essay, I unpick many of these concerns to demonstrate the complexities of the ethics of sustainable investing. Firstly, I outline the intentions of market players who incorporate sustainability considerations in their investment decisions. I focus specifically on (i) investors' pursuit of financial returns and (ii) the priorities of shareholders or beneficiaries. I argue that the former is helpful in explaining the size and shape of the market for sustainable investments.

Secondly, I discuss what we know about the outcomes of sustainable investments. Given the breadth of sustainable finance approaches, investing methods, and asset classes, I focus on green bonds and ESG integration, two of the most common topics to gain public

attention. For both, I demonstrate the challenges of impact accounting, and the importance of detail and care in ensuring that sustainable investment capital is allocated in line with sustainability outcomes.

Thirdly, I discuss the implications of my findings and argue that the adoption of a consequentialist approach is needed among finance professionals dealing with sustainability issues. A nuanced and careful consideration of the outcomes, as opposed to only the virtues of sustainable investments, is needed.

What is in a name?

The definitional challenges behind the sustainable investing terminology necessitate a short pause at this stage. The terms "sustainable finance", "ESG investing", "socially responsible investing" (SRI), and "impact investing" are often used interchangeably. This is likely due to the common connotation behind these terms: that investors include more than only financial considerations when making decisions. Even when the differences between the terms are acknowledged, the definitions are not always consistent across the academic literature and the public domain (see for example the difference between definitions used in Caplan, et al., 2013; Townsend, 2020; S&P, 2020).

One useful way to distinguish between some of these terms is by their approach to value. ESG investing emphasises long-term *investment* value, achieved by incorporating environmental, social, and governance considerations (Investopedia, 2019). This stands in contrast to the older concept of socially responsible investing, which emphasises accounting for *moral* values in investment decisions (Investopedia, 2019). Following this distinction, impact investing can be thought of as a sub-group of socially responsible investing, which strives to identify the most impactful investments.

The other, though related, way to think about the vast sustainable investment universe is that it is squeezed in between traditional investing and philanthropy (see Figure 1, adapted from Paetzold, 2017). Approaches such as ESG integration are thought to be closer to traditional investing, characterised by a greater focus on financial returns. Thematic investing, placing money in investments which have a particular sustainable focus (for example, green investments), and impact investing are closer to philanthropy, driven by values and impacts.

For clarity, throughout this paper, I follow the taxonomy used by Paetzold (2017). This means that I use the all-encompassing term "sustainable investing" to describe investing approaches that include any environmental, social or governance considerations. I use the term "ESG integration" as a way of referencing a sustainable investment approach that takes

into account ESG metrics to drive long-term financial performance. I treat the term “impact investing” as a reference to an approach that prioritises the positive outcomes of investments. As such, I refrain from using the terms “ESG investing” and “socially responsible investing”, though I acknowledge the popularity and long-standing history of the respective terms.

Intentions

How much do sustainable investors value financial returns?

A recent survey of institutional investors found that the most common motivations behind sustainable investing are (i) enhancing returns; (ii) strengthening risk management; and (iii) aligning strategies with the priorities of beneficiaries and shareholders, including those relating to social, political, and environmental values (McKinsey & Company, 2017).

The first two motivations listed in the survey are closely related to the search for long-term investment value. The most hotly debated subject in the sustainable investment literature is, indeed, whether companies with better sustainability metrics have better financial returns.

There is comparatively little evidence that these metrics would be seriously detrimental to financial returns. One of the most influential studies on the subject is a meta-study by Friede, et al. (2015) effectively incorporating two thousand previous empirical analyses. The meta-analysis suggests that various ESG criteria have a non-negative effect on financial performance. This provides - in the words of the authors - an “empirically well-founded” business case for pursuing sustainable investments. That said, the answer varies significantly across studies, depending on the data samples and time periods considered, and on the methods of analysis (Halbritter & Dorfleitner, 2015). It is also worth pointing out that these studies generally focus on investment approaches which explicitly use ESG metrics, such as ESG integration; hence they may not be representative of all sustainable investment approaches.

Figure 1: Taxonomy of sustainable investment approaches

Traditional investing	Sustainable investment approaches					Philanthropy
	Exclusions	ESG integration; Best-in-class	Voting and engagement	Thematic investing	Impact investing	

Source: Adapted from Paetzold (2017).

The focus on financial returns has raised concern among some scholars, who worry that the demand for sustainable investments is increasingly being driven by ethical egoists (Eccles, 2010). A hypothetical ethical egoist, motivated by self-interest, invests in companies with stronger sustainability credentials because they expect better long-term returns and improved risk management practices. As argued by Eccles' (2010) thought experiment on the anti-apartheid socially responsible investment movement, sustainable investing with egotistic motivations may however result in socially malignant decisions. This is because of investors' inability to send a constructive and consistent signal on a given ethical issue, such as apartheid, when their attention rests with the bottom line. The focus on returns has also been criticised more broadly for perpetuating a "business-as-usual" attitude, risking sustainable finance's ability "to [leverage] lasting change for environmental sustainability" (Richardson, 2009).

The concern that such motivations may be insufficient for the financial sector to become a driver for sustainability outcomes gains further traction when we consider the types of sustainable investments which are most popular among investors globally. Negative screening and ESG integration featured in two-thirds of sustainable investments in 2018 (author's calculations based on data from the Global Sustainable Investment Alliance (2018)). In contrast, impact investing and thematic investing featured in only around 3 per cent of the global sustainable investment market in 2018. This points to a very heavy bias towards investment approaches on the left-hand side of the taxonomy in Figure 1, where investment returns matter more than values or impact. As suggested by the data from the Global Sustainable Investment Alliance, these approaches have also experienced remarkable growth since 2016, despite their already very high levels that year.

This points to the fact that financial returns must take centre stage when explaining the current state of the market for sustainable investments. The increased mainstreaming of sustainability considerations in investing seems, at least partly, related to the search for financial returns.

How do sustainable investors incorporate value judgements?

The third motivation mentioned in the survey of institutional investors - aligning strategies with the priorities of beneficiaries and shareholders - directly involves ethical value judgements. These can stem from intentions to "do-no-harm" or to "do-good". "Do-no-harm" motivations, if realised, would reduce negative externalities. "Do-good" motivations create positive externalities. Such distinctions between motivations and the externalities they link to are more common in the literature on

corporate social responsibility (Crilly, et al., 2016) than sustainability investing. However, it is valid also in this context.

Through exclusions, stakeholders may want to avoid investing in companies or industries which they deem unethical, with tobacco companies being the classic example. At the same time, on the other side of the spectrum, stakeholders may want to actively make investments which they think are most likely to have a positive impact. These two sides of the spectrum also happen to coincide with sustainable approaches on opposing sides of the taxonomy in Figure 1: exclusions and impact investing.

As an example, the European Union's Taxonomy Regulation - the EU's classification system for sustainable activities - explicitly features the "do no significant harm" criterion for sustainable activities. By definition, the motivation to "do-no-harm" is likely not to create positive outcomes which "do-good" motivations may create. That said, the former already tackles both willing acts of harm, as well as the mere (intentional or unintentional) allowance of harm to happen. As such, it requires investors to be conscious of the wider context of the investments they make.

Drawing again on the evidence from the report from the Global Sustainable Investment Alliance, we see a high share of investments being motivated by the "do-no-harm" motivation, as opposed to "do-good" considerations. Exclusionary (also known as negative) screening - the classic investing approach demonstrating "do-no-harm" considerations - is the single most common sustainable investment approach globally, featuring in more than a third of sustainable investments worldwide in 2018.

Whose intentions matter?

The presence of many market participants, who sometimes play multiple roles, complicates the analysis of intentions behind sustainable investing. A company issuing a green bond, for example, may have different motivations than the investor purchasing the bond. The former may want to positively contribute to reductions in greenhouse gas emissions by investing in energy efficiency improvements. The latter may view the green bond purely as a good investment, which will decrease the company's operating costs (and hence increase profits) going forward. The situation could also easily turn out to be the opposite. The same company could also purchase green bonds issued by another company under either motivation or have their employees' pensions unknowingly invested in other companies' green bonds.

For this reason, in the second part of this essay, I take a more consequentialist approach to the analysis of the ethics of sustainable investing. Indeed, utilitarianism is the ethical position most commonly used in the analysis of sustainable

investments (Viviers & Eccles, 2012). On the face of it, it should be easier to quantify benefits stemming from investment approaches to the right of the taxonomy in Figure 1, as these approaches target specific projects or outcomes. Approaches towards the left-hand side appear to be more difficult to quantify, as they are woven into more classic investment approaches and target benefits at higher levels of aggregation than individual projects.

In practice, however, impact accounting is extremely hard to conduct across the spectrum. Understanding the impacts of the remarkable growth in sustainable investments is inhibited by the fact that we do not know the counterfactual state of the world in which the investments had not taken place. Instead of attempting the impossible exercise of quantifying the outcomes of specific investments, I evaluate the severity of two problems which inhibit the pursuit of sustainable investment outcomes. I discuss (i) accusations of greenwashing, based on the example of green bonds; and (ii) the criticism of ESG metrics, in relation to ESG integration.

Outcomes

What shade of green are green bonds?

On the face of it, the impact and outcomes of projects done with the help of green bonds (an example of thematic investing, on the right of the taxonomy in Figure 1) are transparent. Regardless of their type or category, the very definition of green bonds indicates that the use of proceeds must be associated with specific environmentally friendly projects (Deschryver & de Mariz, 2020). The first-ever green bond, the Climate Awareness Bond, for example, was issued by the European Investment Bank, with proceeds earmarked for renewable energy and energy efficiency projects (Deschryver & de Mariz, 2020).

Digging a little bit underneath the surface of green bonds, however, we uncover growing concerns about greenwashing, defined as "misleading consumers about […] the environmental performance or the environmental benefits" (Delmas & Burbano, 2011). A recent survey found that over 60 per cent of fixed-income investors view greenwashing as a major concern, in this case among Asian companies (Asset Benchmark Research, 2020).

From a consequentialist perspective, greenwashing is problematic as it undermines the tangible outcomes spurred by sustainable investments. It is easy to see this in extreme cases: when environmental benefits are exaggerated or when the proceeds of a green bond do not end up supporting an environmental cause. Consider for example a green bond issued by the government of Mexico in 2016 and 2017 to help with the construction of a piece of infrastructure. The incoming president scrapped the project in 2018, and soon afterwards the government launched a buy-

back package. However, the residual bonds - while downgraded for their environmental credentials - remain in the market as green bonds (Krebbers, 2019). Since the use of proceeds is now unclear, it is not hard to argue that the bond's green credential is likely to be invalid, despite the fact the bonds may still be included in some green bond indices.

Greenwashing accusations are more difficult to evaluate in cases where the use of proceeds supports an environmental cause, but the broader implications of the investment are less green or less clear. Let us go back to the example of the green bond issued by the Mexican government. If the authorities had not scrapped the project, Mexico City would soon boast another airport, the New Mexico City International airport, funded by green bonds. Yet, even if the project adhered to the strictest environmental standards, the consequences of its creation would likely include increased air traffic, and hence increased CO2 emissions from planes, adding to the stock of CO2 accumulated in the atmosphere and causing climate change. This has led many to question whether the bond deserved a green stamp in the first place (Kapraun & Scheins, 2019).

Green bonds from the Australian state of Queensland faced a similar backlash around the context in which they were issued. While the bonds were earmarked for environmental purposes, including the protection of barrier reefs, the state pursued an expansive coal business at the same time (Financial Times, 2020). On the one hand, Queensland's green bond should please a consequentialist, since - assuming the money is appropriately ring-fenced - their proceeds will only fund environmentally conscious projects. On the other hand, some investors expressed concern that Queensland's access to green funding may hinder environmental causes by perpetuating a business-as-usual mentality (Financial Times, 2020), leading to forgone environmental benefits in the longer run. Concerns have also arisen in the case of green bonds issued by companies with fairly strong green credentials, but poorer social or governance credentials; for example in the case of Walmart (Bowman, 2019).

The examples above point to the difficulty associated with assigning the binary "green" tag to bonds. This is due to the unenumerable consequences associated with every investment - many of which are clear from the onset, others becoming apparent only over the longer term. Unsurprisingly, growing greenwashing concerns have led to the emergence of "dark green" investments, a colour that is meant to signal extra scrutiny in applying the label, in contrast with light green investments (Deschryver & de Mariz, 2020). The Climate Bonds Initiative, an international organisation, has also promoted the use of climate bonds whose

sustainability credentials are subject to verification and a review process based on a set of Paris-alignment criteria. The emergence of such initiatives - both dark green bonds and climate bonds - demonstrates the growing necessity for outcome-orientation in sustainable finance. They also demonstrate how wide is the spectrum of what currently constitutes sustainable investments.

Looking beyond green bonds, we see that the same complexities apply to other types of sustainable investments. The term "impact washing", going beyond green-washing more generally, is now also gaining prominence.

Does ESG integration allocate capital efficiently to most sustainable companies?

Some of the concerns around greenwashing in the context of green bonds have led to the increasing popularity of sustainability-linked bonds (Financial Times, 2020). These are bonds whose interest rates are linked to performance in specific quantifiable targets; for example greenhouse gas emissions intensity or the company's ESG metric. The integration of ESG ratings in investments brings us to the opposite (left) side of the taxonomy in Figure 1, where - arguably - understanding the impacts of specific investments becomes even more difficult. These approaches take the focus away from specific projects and instead put more emphasis on the performance of a company as a whole.

ESG integration is "the explicit inclusion of ESG opportunities and risks in traditional financial analysis and investment decisions of asset managers" (Wild, 2017). Such inclusion can take many forms, from qualitative to - more often - quantitative, and provides asset managers with "signals that encourage investment in more sustainable regions, sectors, and companies" (Wild, 2017). As such, the accuracy and consistency of the signals underpin the whole investment approach. These signals take the form of ESG metrics. Increasingly, however, concerns have arisen over (i) self-reported disclosures of raw data or indices of companies' performance; and (ii) the methods used to process and aggregate the raw data.

Let me start by focusing on the raw ESG data, as reported by individual companies. As suggested by Kotsantonis and Serafeim (2019), "data inconsistency is worse than you think." Having reviewed disclosure on employee health and safety from a random sample of fifty Fortune 500 companies, the authors found it challenging to make any comparisons of performance. This is because of the myriad of indicators used to demonstrate employee health and safety performance. Such incomparability is a common problem. A McKinsey Sustainability Reporting Survey has found that "inconsistency, incomparability, or lack of alignment in standards"

(McKinsey & Company, 2019) are a top challenge associated with current sustainability-reporting practices. The same source quotes a major asset manager who lamented that "[w]e have positions in over 4,500 companies. Unless [sustainability information] is comparable, hard data, it is of little use to us."

Such problems with self-reported data and indices come despite cross-organisational efforts and initiatives to develop common reporting standards. While the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI) have been instrumental in this area, reporting practices continue to differ significantly within and across sectors. The reliability of self-reported data has also been questioned, due to unclear data gathering practices, leading to calls for audits of sustainability disclosures (Benow, et al., 2019). This stands in sharp contrast with high reporting standards and audit practices used for financial disclosures.

How companies' raw data is being processed and aggregated has raised further concern. Kotsantonis and Serafeim (2019) specifically point to problems with (i) benchmarking; and (ii) with different imputation methods to produce final metrics. According to the authors, the process of benchmarking, or assessing a company's performance within a range of other companies' performances, often lacks transparency. While it may appear to be a mere methodological detail, the choice of the comparison group - be it a set of all companies or only companies in the sector - matters a lot for the final result. Kotsantonis and Serafeim (2019) demonstrate that the same company can be either a top performer or a mid-performer, depending only on the choice of the peer group. Imputing missing data, which happens often as companies rarely provide the same information, can also be done in a variety of ways, again allowing the possibility that the same set of inputs yields contrasting results.

Altogether, this has led to little agreement across data providers when creating a metric of a company's sustainability performance. A recent study has found that the average correlation between a company's ESG ratings produced by different data providers is poor (only 0.4), while alignment is close to perfect for issuers' credit ratings based on financial performance (OECD, 2020). Worryingly, the disagreements between data providers actually grow with the amount of publicly available information (Kotsantonis & Serafeim, 2019). At the same time, Drempetic, et al. (2020) noted a significant positive correlation between company size and ESG score, suggesting that the way in which the scores are compiled may give an advantage to large firms due to higher organisational legitimacy.

The fact that ESG metrics can differ so significantly for the same company suggests that they may not help investors allocate

resources in companies with the best performance in matters relating to the environment, and social and governance performance. By extension, this also means that these methods may not lead to optimal ESG outcomes and not incentivise companies to act in a way that will achieve the most impact, only in ways which maximise their scores.

As with the discussion of green bonds previously, a careful consideration of details around investment products is crucial. Alignment in indices, uniform units, and transparency do not immediately appear to be decisive for the success of sustainable investing. The literature on the link between ESG and financial performance does not address these topics frequently. In fact, as suggested by Kotsantonis and Serafeim (2019), it is remarkable that "we find signals and meaningful relationships with economic outcomes given the poor quality of the data". Given the volume of money invested in approaches such as ESG integration and green bonds, these seeming details nonetheless make a big difference for a consequentialist

Where do we go from here?

Sustainable finance is no longer in its nascence. Yet more than ever, it needs a clearly specified direction and set of objectives. If current growth continues unchecked, sustainability investing will enter the investing mainstream. There is already much pressure on fund managers to keep sustainability on the agenda; the pressure is likely to only intensify in the coming years. While there is much appeal in seeing more growth in sustainable finance, this growth and popularity come with caveats.

As demonstrated in earlier parts of this essay, a large share of sustainable investments is focused on approaches that emphasise and prioritise the bottom line. Such focus, while good for growth in such investments, may not lead to sweeping changes to sustainability outcomes. This comes as exclusionary practices, the single most common approach in sustainability investing, actively prioritises avoiding harm, as opposed to creating a positive impact. At the same time, ESG integration - the second most common approach globally - relies on metrics that are often inconsistent across data providers, putting their reliability into question. Other types of sustainable investments such as green bonds are also increasingly facing scrutiny over their eventual impact and outcomes.

Much depends on whether finance professionals see sustainability as a feature of business-as-usual investment decisions, or whether they want to use finance to actively tackle sustainability concerns. As we have seen throughout this essay, these two goals do not overlap perfectly, but they are also not mutually exclusive. Importantly, however, a consequentialist mindset is helpful in either case. As companies'

approach to sustainability is likely to have an impact on their long-term financial performance, finance professionals need reliable information on the companies' sustainability performance. There is no better measure of sustainability performance than tangible impacts on people and the environment. At the same time, if finance is the way to tackle the problems of our times, we also need finance professionals to be able to discern where actual impact is being made.

The adoption of a focused, consequentialist mindset is needed among finance professionals who deal with sustainable investments. Greater attention and awareness need to be placed on the impacts and outcomes of specific investments, as opposed to their proclaimed virtues. This includes the need for finance professionals to turn their attention to the more gruelling fine-print details, and absolute and relative benefits and outcomes. Such an approach would address much of the criticism of sustainable investing, including accusations of green-washing, impact-washing, and virtue signalling. As an extension, it would also actively help tackle some of the burning problems of our times.

A systemic reorientation towards the outcomes of sustainable investments would require a coordinated effort, including in the form of improved disclosure practices of companies, consistent methodologies of data providers, increased transparency of both data producers and data handlers, and strengthened regulatory environment. This would likely impose additional costs on companies and investors, including costs related to data gathering, disclosure, or audit. Higher costs may halt some of the impressive growth we have observed in recent years, though it is arguable that the reorientation may eventually lead to improved sustainability outcomes.

Some reorientation is already on its way. While the growth in sustainable investments globally has gone largely unchecked by regulators, this is now changing, particularly in Europe, the largest market for sustainable investments (Global Sustainable Investment Alliance, 2018). New regulation and guidelines, mostly coming from and being applied to European finance, include a range of abbreviations, such as EU GBS (EU Green Bond Standard); SFRD (Sustainable Finance Disclosure Regulation); ESG risks in ITS (Planned incorporation of ESG risks in the European Banking Association's Implementing Technical Standards); the EU Sustainable Finance Taxonomy; and TCFD (Task Force on Climate-Related Financial Disclosures). Some of the new rules and regulations aim to solve the very problems discussed in this essay, for example by providing clear definitions of green activities and unifying disclosure practices. European regulations may also have spillover effects on companies in other jurisdictions, which both sell

their products in Europe and buy products from Europe.

However, it is still too soon to say if any regulation or guideline will match the scale of impact of the "Global IFRS revolution" (Zimmermann & Werner, 2013). In the span of a few years, International Financial Reporting Standards, led by the International Accounting Standards Board, replaced several other competing accounting standards. Eventual convergence in standards meant that companies' performance could be compared directly, greatly simplifying investors' decision-making. Such convergence is needed and much anticipated for sustainable finance.

In the meantime, greater appreciation of the differences in products and approaches in the market for sustainable developments would be a welcome development to ensure outcome-orientation. This could mean, for example, increased differentiation between investments which are compliant or non-compliant with specific guidelines and regulations. This is already the case for example with Certified Climate Bonds (which, however, constituted only a small fraction of the green bonds market in the first three months of 2021 (Climate Bonds, 2021)). Similarly, investments could also be differentiated along the "do-no-harm" and "do-good" axes, "assured" and "not-assured" sustainability credentials, or along the "impact-aligned" and "impact-generating" spectrum, as suggested by Busch, et al. (2021). As the sustainable investment universe grows larger every year, more nuance is needed to ensure that capital is allocated in accordance with sustainability outcomes.

Conclusions

In this essay, I discussed (i) the intentions behind sustainable investing; and (ii) the need to focus on specific outcomes and impacts of sustainable investments. The essay's conclusions can be summarised by the following points:

Intentions: The sustainable investments universe is dominated by sustainable investment approaches most closely related to traditional investing, such as exclusionary screening and ESG integration. This is consistent with investors' motivations to seek improved financial returns, as opposed to creating most impact. Relatedly, the most popular sustainable investment approach globally - exclusionary (or negative) screening - reflects investors' "do-no-harm" considerations, as opposed to "do-good" considerations.

Outcomes: Greenwashing and problems with ESG metrics inhibit the ability of green bonds and ESG integration to deliver on sustainability outcomes:

Greenwashing is an important concern among investors, as demonstrated by the example of green bonds. The rise of "dark green" investments and climate bonds reflects the growing calls for

nuance, detail, and assurance in sustainability investments;

The concern with ESG ratings goes deeper than analysts' or economists' usual concerns over data limitations. Lack of alignment in ESG metrics is a structural issue that undermines the ability of investors to allocate capital optimally to companies with sound ESG performance. ESG ratings stand in stark contrast to credit ratings – used to help investors allocate capital to companies with sound financials - which are almost perfectly aligned, having the underpinning of unified accounting standards.

A consequentialist mindset is crucial among finance professionals engaged in investing in sustainability. The focus on the outcomes of sustainable investments, as opposed to their virtues, may halt some of the impressive growth in sustainable finance. Yet those seeking to maximise long-term gains, and those hoping to use finance as a way to tackle problems of our times, both stand to gain from a reorientation to impact. •

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"...the economy itself cannot be limited to production and distribution. It must also consider its impacts on both the environment and on the dignity of people" – Pope Francis (Francis, 2020)

Introduction

As global emissions bounce back after a year of pandemic lockdowns (IEA, 2021a), the world must enact a tectonic shift in production and emissions patterns. Global finance is key to this transition: in many cases, banks and investors own or manage more assets than the gross domestic product (GDP) of an entire country. For example, a recent review of the world's largest banks found that even the 100th largest bank, Qatar National Bank, holds more money in assets ($281bn) than 150 countries in the world produce in annual GDP (Feliba & Ahmad, 2021; *GDP by Country* 2017).

Financing solutions to climate change is thus a moral imperative, and one that Pope Francis highlighted in his encyclical letter *'Laudato Si'*, which emphasizes the need to invest in renewable energy and divest from fossil fuels (Francis, 2015). The financial sector is beginning to take note: since the Paris Agreement was signed in 2015, more than twenty coalitions and frameworks have been formed to address the role of financial institutions in combatting climate change; half of these initiatives started in the past two years alone (Tonkonogy & Choi, 2021). Three of the largest initiatives – the Task Force on Climate-related Financial Disclosures, Glasgow Financial Alliance for Net-Zero, and Climate Action 100+ – now collectively own

or manage $272 trillion in assets (Task Force on Climate-related Financial Disclosures, 2017; United Nations Climate Change, 2021; Climate Action 100+, 2020).

However, there exists a gap between the goals of these groups and actual climate action, due in part to a lack of guidance around how to fund businesses with low emissions and/or credible decarbonization plans, and when to defund businesses with high emissions. This will require improved reporting of company emissions, clearer frameworks for setting and tracking climate finance goals, and better country policies to enable universal adoption of these approaches.

Financial institutions looking to invest in climate finance should thus: learn from country-led climate finance lessons regarding the importance of ethics in determining large-scale outcomes (section 1); set ambitious climate targets (section 2); leverage investments or lending practices to influence broader corporate change (section 3); and increase funding to organisations serious about transitioning to a low-carbon future (section 4).

Most importantly, financial institutions must incorporate ethics into each of these approaches in order to ensure that the climate transition is a *just transition* (section 5). There are no easy social metrics to use off-the-shelf here, which makes it imperative for qualitative assessments to be embedded across the sector's value chain. Ultimately, financial institutions must re-align the sector to value environmental and social externalities that are critical to ensuring a net-zero world.

Two steps back without the inclusion of ethics in climate finance

"[President] Moreno is giving away our forests and territories to oil companies and taking away our ability to move around the country. The government needs to protect its people, which means guaranteeing our rights, ensuring basic means of transportation, and protecting the forest as well as our climate.» – Domingo Peas, an Achuar Indigenous leader (*Brutality, Violence, and Repression in Ecuador*, 2019)

The removal of fossil fuel subsidies is a critical step in addressing global emissions, and one that needs to happen as soon as possible, at the greatest scale possible. However, a 2020 study found that thirty-five of the world's biggest banks provided a record $735.6 bn in lending and underwriting to the fossil fuel industry (BankTrack et al., 2020).

If these banks are to take serious action on climate change, there are lessons to be learned from political attempts to shift funding such as subsidies away from fossil fuels. In 2019, Ecuador's President Moreno announced the removal of fossil fuel subsidies within the country. This removal made both climate and economic sense: Ecuador spent an average of $1.4 bn a year on subsidies and this removal was a condition for

accessing an International Monetary Fund (IMF) loan of $4.2 bn (Arnold, 2019).

Yet less than one week after the government of Ecuador signed Decree 883 to eliminate these subsidies, Quito lay under a thick cloud of tear gas. Key members of the Moreno government, including President Moreno himself, fled to the coastal city of Guayaquil as indigenous peoples, students, and blue-collar workers from around the country converged on the capital in protest. As the protests intensified, President Moreno ultimately agreed to repeal Decree 883.

As the case of Ecuador shows, these changes cannot occur without careful ethical considerations of the impacts of such policies on vulnerable and low-income communities. While the IMF concluded that reforming the fuel subsidies would "allow for an increase in social assistance spending" (International Monetary Fund, 2019), this was not communicated in a way that engendered trust from key constituencies.

Instead, President Moreno's announcement immediately caused diesel prices to more than double and gasoline prices to rise by 25 per cent, thus disproportionately impacting rural communities, especially Indigenous Peoples, who had limited alternative transport choices (Monahan, 2020).

In Ecuador, as in many former colonies, Indigenous Peoples and other historically marginalised groups lack trust in the government. Rising petrol prices simply added to a historical stack of oil-related grievances that started in the 1970s with the government's exploitation of the Amazon for oil. While both the government and private companies profited from this extraction, the local communities did not receive much, if any, financial compensation and were saddled with higher mortality and other health risks (San Sebastián, M., & Hurtig, A-K., 2004; Kimerling, 2006). To add salt to the wound, the IMF itself had previously required Ecuador to expand oil production in order to manage the country's spiraling debt, most of which originated from Ecuador tying increased public spending to high oil prices and then failing to diversify when those prices crashed (Cueva & Díaz, 2019).

Thus, the subsidy removal did little to address the root causes of Ecuador's emissions and debt, while shifting the burden of payment onto the country's most vulnerable populations.

In other countries that have successfully removed or limited fossil fuel subsidies, their success was reliant on improved stakeholder engagement with affected workers, targeted investments in social safety nets, increased job opportunities within renewable energy sectors, and clearer communication about the benefits of these reforms (Merrill & Quintas, 2019). A New Climate Economy report also found that successful transitions

required extensive dialogue with the affected stakeholders and designing more targeted benefits for these communities. For example, when China shuttered 151 coal plants, the government ensured that significant funding ($15 bn) was invested in the retraining and early retirement of these workers (Global Commission on the Economy and Climate, 2018).

Addressing climate change inherently requires ethical considerations as many of the most vulnerable people are those facing the largest impacts from rising temperatures and sea levels – although these same people contribute the least to this global catastrophe (Abeygunawardena & Sperling, 2003). While governments have led the global response to climate change to date, it is arguably financial institutions that hold the most capital and can enact the most meaningful change. Ecuador's GDP, for example, is only $107.4 bn; meanwhile, a single bank, JPMorgan Chase & Co., provided $64.9 bn to the fossil fuel industry in 2019 alone and holds an additional $3.4 trillion in assets (BankTrack et al., 2020; Feliba & Ahmad, 2021).

Too big to ignore: the financial sector must set climate targets

"Climate change is the greatest market failure the world has ever seen." – Sir Nicholas Stern (Stern, 2006)

Although each country has established a climate target through the Paris Agreement, such targets, if achieved, will only limit global warming to 2.4° Celsius (C) (*2100 Warming Projections*, 2021). There is a clear and urgent need for the private sector, and in particular the financial sector, to help close this gap between existing targets and what we currently know is scientifically needed, which is well below 2°C, closer to 1.5°C (Paris Agreement, 2015).

To begin with, financial institutions must set a 2050 emissions reduction target in line with a well-below 2°C or 1.5°C trajectory. Yet setting such targets is fraught with uncertainties. Most financial institutions can easily calculate and set achievable targets for scope 1 (direct emissions) and scope 2 (emissions from electricity use). However, the overwhelming emissions come from scope 3 (all other indirect emissions): essentially, this includes emissions from any company that has received an investment or a loan, and most of these companies have not calculated their own emissions.

Historically, frameworks have not provided a scope 3 methodology, yet in this past year alone, both the Partnership for Carbon Accounting Financials (PCAF), led by a coalition of Dutch banks (PCAF, 2021), and the Science-based Targets Initiative have shared pilot approaches (Yan et al., 2021).

Recent analysis using the PCAF methodology found that banks and asset managers in the United

Kingdom (UK) alone finance more than 805 million tonnes of carbon dioxide or other greenhouse gases ($MtCO_2e$) a year: nearly double the UK's emissions and more emissions than all but nine of the world's largest emitting countries (WWF & Greenpeace, 2021).

As the bulk of emissions stem from scope 3, it is imperative that financial institutions begin to account for and target these emissions in climate goals, even given the uncertainty still associated with these approaches, as there is a clear scientific – and thus moral – basis for acting against climate change now as opposed to delaying interventions years later (i.e., the cumulative effect) (Rhys, 2011).

Such targets must approach the inherent uncertainty in setting a 2050-aligned goal in a value-driven way. At the moment, many countries, companies, and financial institutions have adopted *net-zero* targets, which gives them some flexibility regarding exactly how much emissions must be reduced (*reductions*) compared to how much emissions already in the atmosphere can be later removed (*removals*).

There are well-documented concerns with an over-reliance on removals. The primary worry is the uncertainty and the timescale: if carbon removal technologies do not materialise as expected by 2050 (or do not materialise at the expected price point), then companies and financial institutions will have already locked the world into a high-temperature pathway with few alternatives planned (Anderson & Peters, 2016). Future faith in removals could therefore impede adequate priority being given to mitigating emissions now.

Additionally, most technological removals solutions do not address the social injustices caused by emitters today. For example, if a factory continues polluting because it plans on later removing carbon from the atmosphere through carbon capture and storage (CCS), the negative air quality and health impacts on local – often vulnerable or low-income – communities will still not be resolved. This highlights the need to consider climate commitments and action through a social equity lens in addition to a pure emissions view.

The financial sector is in a unique, and difficult, position when ascertaining how and when to lend or invest in various companies based on a well-below 2°C or 1.5°C pathway. That is because progress in one sector may not be feasible for another, especially in hard-to-abate sectors.

The aviation sector, for example, has potential decarbonisation pathways through the production of sustainable aviation fuels and/or the electrification of planes. However, neither of these solutions is currently commercially available at a scale needed to transform the industry (Sustainable Aviation Fuel: Review of Technical Pathways, 2020; Coren, 2020). As a result, the International Civil Aviation

Organization (ICAO), when setting an industry-wide climate target of carbon-neutral growth post-2020, decreed that airlines must purchase carbon credits in the meantime until such solutions are available (ICAO, 2019). However, there are similar ethical concerns around the long-term reliance on carbon credits to those around removals; ultimately, internal decarbonisation is needed by 2050.

While it is imperative that the financial sector sets climate targets inclusive of all emission scopes, there is still debate and experimentation around how best to implement these goals and the role of removals and carbon credits in helping address the uncertainty in meeting a target that is five, ten, or even twenty years in the future. What is certain is that these targets must be set, and lessons must be learned along the way – the time for waiting is over.

Moral imperative to change the fossil fuel status quo

"Investor engagement has been key to delivering the wave of net-zero commitments from companies during 2020. Firms yet to come forward with net-zero plans will come under growing pressure as investor willingness to escalate their engagement will be the new norm. Work will also continue to support those companies that substantiate net-zero goals with robust business strategies. Long-term ambition needs to be made real with clear short- and medium-term targets, and capex alignment to support delivery of those goals." – Stephanie Pfeifer, Chief Executive Officer of the Institutional Investors Group on Climate Change (Climate Action 100+, 2020)

In addition to setting their own targets, financial institutions hold a uniquely influential position with recipients of their financing: these relationships can be leveraged to push companies to adopt ambitious climate targets, disclose relevant climate and social data, and advocate for supportive policy by governments to enhance and require these approaches.

This can be accomplished through shareholder engagements and resolutions. For example, Ceres, a network of financial institutions and companies committed to building a sustainable future, encourages its Investment Network members to file shareholder resolutions regarding climate, energy, water, and sustainability (*Engagement Tracker*, 2021). In 2020, the non-profit recorded 131 climate-related shareholder proposals; 70 will be voted on, while 42 were withdrawn in exchange for climate commitments by the company in question (Berridge, 2020).

Most recently, activist shareholders won two victories with ExxonMobil and Chevron. In May 2021, Chevron investors voted for a proposal to increase the company's emission reduction targets, while on the same day, two climate activists were elected to ExxonMobil's board via a proxy campaign (Mufson, 2021).

Financial institutions can also take a more direct, targeted approach. The Climate Action 100+ encourages financial institutions to engage with 167 of the world's top greenhouse gas emitters and companies that are critical to a low-carbon transition through collaborative, targeted engagement with company executives and board members. In its 2020 progress report, as these companies also grappled with the unanticipated impacts of COVID-19, Climate Action 100+ found that almost half (43 per cent) of the companies had net zero commitments; however, only 10 per cent of companies included scope 3 emissions in their targets. The progress report concluded that there is a need for additional guidance around the benchmarking and scoring of company climate plans, sector-specific decarbonisation pathways, and more specific approaches to lobbying and a just transition (Climate Action 100+, 2020).

Both Ceres and Climate Action 100+ approaches focus on large, global companies, many of which include the world's top polluters. From an ethical standpoint, it is necessary to either divest completely from top polluters or to actively engage to enact change in such corporations and communicate this to the public.

These two paths can be seen in Norway's Council of Ethics for its Government Pension Fund Global, managed by Norges Bank. The guidelines allow for both positive screening (investing in best-in-class companies with strong climate targets, even if existing emissions are high) and negative screening (refusing to invest in high-emitting companies at all) (Norges Bank Investment Management, 2016). A positive screening approach should be continually reassessed; the ethics guidance specifically states that "companies may be excluded or placed under observation if there is an unacceptable risk that they contribute to or are themselves responsible for… acts or omissions that on an aggregate company level lead to unacceptable greenhouse gas emissions".

In the Council's annual 2020 report, it reported excluding four companies that extracted oil from oil sands on these grounds. Additionally, of the 314 companies the fund divested shares from due to risk, 170 were divested based on climate risk (Council on Ethics for the Norwegian Government Pension Fund Global, 2020).

There may also be an ethical dilemma closer to home in the making. Norway's wealth stems primarily from oil production and export; the pension fund's purpose is to invest wealth from Norway's petroleum sector. While Norway's state-owned company Equinor – which changed its name from Statoil in 2017 to emphasize its broader focus as an energy company and not just an oil company (Sætre, 2021) – does not explore heavy oil or oil

sands, the company continues to explore for new oil and gas fields (Equinor).

The International Energy Agency recently made international headlines by concluding that there is no room for investment in new fossil fuel supply to meet net-zero by 2050 (IEA, 2021b). It remains to be seen whether Norway's Council of Ethics will opine on Equinor's future expansion plans, or whether the company will align itself with the latest science on the transition needed by the oil and gas industry.

Trust, but verify

"…developed countries [must] commit to a goal of mobilizing jointly USD 100 billion dollars a year by 2020 to address the needs of developing countries. This funding will come from a wide variety of sources, public and private, bilateral and multilateral, including alternative sources of finance." – The Copenhagen Accord (Copenhagen Accord, 2009)

The Intergovernmental Panel on Climate Change estimates that $3.8 trillion in investments is needed annually to transition the world to a 1.5°C trajectory; however, the Climate Policy Initiative only tracked an estimated $608-622 bn in investments in 2019, of which a little more than half was from private funding (Macquarie et al., 2020). In addition to this finance being grossly inadequate to address the growing scale of the climate crisis, there is another problem: how to tell whether these "green" investments are actually making a difference to the atmosphere, and not causing additional harm to ecosystems or society.

Climate finance typically measures success purely in terms of emissions reduced. However, this has led to ethical issues where coal plants, crude oil combustion, thermal power plants, and other heavy emitting industries can receive recognition for and access climate finance by switching to more efficient processes or other fossil fuel sources with slightly less environmental impact. As a result, initiatives like the Clean Development Mechanism (CDM), a United Nations carbon credit programme, approved methodologies such as *ACM0013*, which allowed coal plants using a less-intensive technology to earn carbon credits. Unfortunately, many of these plants will operate for at least 30 years, meaning that this mechanism encouraged and locked in emissions rates for decades after the initial sale of carbon credits (Lazarus & Chandler, 2011).

This trend continued in 2015 when multilateral development banks such as the World Bank, Asian Development Bank, and the European Investment Bank produced a joint document on "Common Principles for Climate Mitigation Finance Tracking" (2015), that lists projects like "thermal power plant retrofit to fuel switch from a more greenhouse gas (GHG) intensive fuel to a different, less GHG-intensive fuel type" (p. 3) as an appropriate

activity to access climate mitigation finance. The document provides some slight nuance that the CDM lacked, noting that in fossil fuel sectors, it is important for the banks to consider the structural impacts of these investments and seek to prevent long-term lock-in of high carbon infrastructure (Common Principles for Climate Mitigation Finance Tracking, 2015). However, specific details were not provided about how to determine the credibility of these approaches.

In many cases, a proposed approach can be nuanced and require an ethical framework. In 2017, for example, the oil and gas company Repsol announced a green bond that would finance energy efficiency investments in many of the company's chemical and refinery facilities that would avoid an estimated 1.2 million tonnes of CO2 ($MtCO_2e$) annually by 2020. Fewer emissions overall are, objectively, a good thing for the atmosphere. However, Repsol produced 19.7$MtCO_2e$ of direct scope 1 emissions in 2016; its indirect scope 3 emissions would be at least an order of magnitude higher. In this context, the proposal is wholly inadequate to seriously address the company's emissions. The Climate Bonds Initiative, which considered listing the bond, concluded that "we do not regard this bond as '*greenwashing*'… but this highlights the challenge in dealing with complicated emissions questions; exactly the area where clear science-based criteria would make life easier for both issuers and investors" (Whiley, 2017).

In an attempt to provide transparent guidance on whether a company is making a good-faith attempt to address its climate impact, the Climate Bonds Initiative and Credit Suisse recently issued a joint paper proposing a *transition* framework. This guidance helps to determine whether companies in hard-to-abate sectors are eligible for a transition label, which recognises investments that are not green, but which do "have a short-term role to play in decarbonizing an activity or supporting an issuer in its transition to Paris Agreement alignment" (Almeida et al., 2020). The framework aims to provide key criteria to ensure that these labels are not effectively greenwashing a company's high emissions and propose clear roles for what constitutes a green label compared to a transition label (Climate Bonds Initiative, 2020).

As the financial sector becomes more mature in its understanding of climate risk, there could foreseeably be mixed loan or investment funds that seek to maximize financial and climate returns while weighing the risk of failure and/or greenwashing. Such a portfolio might include several guaranteed climate outcomes, such as investments in renewable energy companies, while also making calculated investments in transition companies that could pay off with both financial and climate dividends on a much larger scale. This

approach will be instrumental in moving the needle towards making climate finance mainstream.

Addressing the tragedy of the commons

If someone hit someone else, it was clear who had done what and why it was wrong. […] Today, by driving your car you could be releasing carbon dioxide that is part of a causal chain leading to lethal floods in Bangladesh" – Peter Singer, Philosopher (Singer, 2016)

Climate change has a uniquely decoupled spatial relationship from cause to effect: one tonne of carbon dioxide or equivalent gas can be emitted anywhere in the world and have the same effect on the climate. Likewise, a changing climate can, in turn, cause natural disasters in areas with historically low emissions. This is at the heart of climate change ethics, and in the United Nations Framework Convention on Climate Change negotiations: developing countries, whch historically had low emissions and many of which continue to have low emissions today, are often predicted to be disproportionally impacted by climate change (and to have the fewest resources to adapt to these impacts).

With regard to climate finance, then, ethical considerations must not only focus on the duty of a financial institution to reduce its own emissions or the emissions of those it has loaned or invested in but also the duty to address the impacts of a changing climate on the world's most vulnerable populations.

Yet how can financial institutions measure this impact? Often, the question of which metrics to use to ensure an equitable climate transition is left absent or undefined in climate finance working groups and guides. One group, the Climate Action 100+, has plans to build out its "Just Transition" requirement for companies. At the moment, however, this section has only one sub-bullet, which states: "The company considers the impacts from transitioning to a lower-carbon business model on its workers and communities." Further requirements are still in development (Climate Action 100+, 2020).

There have been many studies estimating the cost-benefit of social outcomes; however, these are often not incorporated into real-world financial investment decisions. A recent IMF study examining the role of post-COVID recovery investments found that clean energy investments produce more jobs and other economic benefits, while similar investments in fossil fuel technologies underperform in both additional economic and social benefits. The study also found that investing in conservation produced multiple social and ecological returns compared to investments in industrial agricultural processes (Batini et al., 2021). Investing in nature also has another crucial benefit in fighting the spread of zoonotic diseases, such as COVID-19, as these diseases usually occur in areas where deforestation occurs (OECD, 2020).

One simple proposal is to quantify these social and environmental externalities. However, quantifying biodiversity or improved health is less straightforward than measuring greenhouse gas emissions. An analysis of conservation investments found that financial institutions most commonly used third-party standards to verify the emissions reductions from these investments but relied on internal criteria to measure social and other ecological impacts (if measured at all). In some cases, investors cited a lack of standardised metrics as a reason for using internal criteria; in other cases, investors preferred internal criteria because these criteria were custom-made and were more nuanced than third-party certifications (Hamrick, 2016).

This illustrates the tradeoffs in trying to define, quantify, and track climate finance under a just transition framework: such metrics might oversimplify an inherently complex topic, resulting in added cost without added value.

Already, participation in climate finance remains low by private financial institutions. Since 2015, some of the world's largest public development banks have tried to leverage private sector finance: the idea was that billions in public sector dollars could unlock trillions in private sector finance. However, only the Africa Development Bank managed to incentivize matching private investment during this time (Thwaites, 2020). Thus, while adding metrics around a just transition could result in more durable, long-lasting results, it also could add another finance barrier to engagement by the financial sector.

Even if simplified metrics were designed, this simplicity might not adequately address the risks in ensuring these decisions have legitimacy within a community or political setting. This argues for a holistic approach towards climate justice, which an approach such as divesting from fossil fuels might overlook. Thus, while financial institutions should encourage working groups and guidelines to explore criteria around a just and sustainable transition, these decisions must ultimately occur at the organizational level. At the end of the day, financial institutions must seek twin goals of ensuring that a low-carbon transition is a just transition.

Conclusion

Each year of climate inaction risks locking in higher temperatures by 2050. Transforming sectors to low-carbon or zero-carbon cannot happen without serious engagement by the financial sector. Climate finance is not currently competitive with traditional finance, since greenhouse gas pollution remains an environmental externality.

To even the playing field, financial institutions must adopt science-aligned climate targets, use their platforms to ensure borrowers and

investees make similar goals, and, most crucially, begin implementation to realise these outcomes as soon as possible, all while using climate justice as a guide in all financial and operational decisions.

Momentum is growing for the financial sector to address climate change more seriously. In the upcoming climate negotiations later this year, climate finance will be in the spotlight as negotiators discuss whether to extend or raise a 2009 pledge to mobilize $100 bn annually to help developing countries transition to a low-carbon economy (Copenhagen Accord, 2009). The financial industry must be ready to step up and take responsibility for its role in perpetuating the high emitting status quo of the global economy and be willing to lead in the transition to a low-carbon future.•

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Can ESG and Sustainability Create Value Effectively for Private Equity ?

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Finalist

Georgia Deda-Heude
United State
Visiting Associate,
*Boston Consulting Group**
Milan (Italy)

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While sustainable development is not a new term for economists, consideration of sustainability and ethical factors in finance is a relatively recent concept. Sustainability and ethical concerns are mainly reflected in finance through increased attention to Environmental, Social and Corporate Governance (ESG) considerations in investments. As far as Private Equity Investments (PEI) are concerned, they have been historically led and will continue to be led by profit, regardless of their nature. Nonetheless, Private Equity (PE) will have to progressively include ESG factors in their operations.

The paper contributes to the existing body of knowledge by investigating the latest generation of PE Funds (PEF) which are attempting to use ESG to "create more value with less risk" (Indahl and Jacobsen, 2019). The paper also seeks to understand whether PEI, as time-bound short-term financial tools, could be an instrument for long-term planning, fostering sustainability and enhancing an ethical approach to investments; and whether, in doing so, value can still be created, if not increased.

The paper is based on a review of existing literature on the issue. In addition, as the topic discussed is rather recent - and thus the literature is limited - the paper is supported by targeted interviews of managing partners and directors of some well-known PEF with offices in Europe and of members of the Italian Private Equity, Venture Capital and Private Debt Association (AIFI) who operate mainly in Europe.

The originality of this paper lies in the fact that it weighs all the pros and cons related to the use of PEI as a tool to foster sustainability and reinforce an ethical approach to investments and tries to identify the ways in which ESG can be leveraged to create value in the industry, and whether these levers are already used or should be further exploited by the industry. The paper also develops various recommendations that could be useful to the industry to seize the opportunities offered by ESG for value creation.

PE and the components and dimensions of sustainable finance

When it comes to the evolution of the industry, Indahl and Jacobsen (2019) divide PE's history into four time periods. According to them, during the 1980s, leveraged buyouts (LBOs) were used to create value through financial engineering. High leverage coupled with large equity stakes were used to motivate managers to cut the costs of mature businesses. "PE 2.0" developed in the 1990s and focused extensively on increasing operating efficiencies by hiring successful CEOs. The 2000s brought the third wave of PE, characterized by large financial institutions that "continued to function as value-added buyers" and expanded into multiple asset classes and new areas of expertise. The latest generation is defined as "PE 4.0: Using ESG to Create More Value with Less Risk". As seen by the various versions outlined by Indahl and Jacobsen (2019), PE is a malleable and forever changing form of investment type, which makes it a good candidate for adapting to the constantly changing needs of the future.

Environmental, Social and Corporate Governance factors, also known as ESG, are now considered central pillars in measuring the ethical, environmental and social impacts of investments and businesses. Added together, the three ESG factors describe "sustainability". However, there exists a plethora of definitions of ESG factors in the literature, each stressing a particular aspect, mostly related to the nature of a business and its products and services.

In general, *Environmental* considerations focus on a company's impact and ecological footprint, whether it relates to its waste production, use of energy or pollution of land, air or water. Recently, increasing attention is also being paid to climate change concerns, highlighting the ability of a company to limit and/or offset its greenhouse gas emissions.

Attention to *Social* standards covers a wide range of issues, from the health and safety of workers to labor fair practices and standards throughout the value chain, as well as general ethical factors. Human rights concerns, gender and diversity, and animal welfare are also aspects considered by many companies.

Governance aspects are even more complex and difficult to define, as they address a vast array of issues and standards for running a company. Overall, governance refers to the management and leadership of a company, including aspects such as salaries and compensation, employee conditions and relations, controls and audits, and concerns over bribery and corruption. Governance can also refer to the ability of the company to align with the interest of its shareholders and in some cases, political contributions and sustainability standards in local countries, particularly for multinationals.

Why the shift towards sustainable investments?

The author identifies three main reasons for a transition toward sustainable investments: (i) a *bottom-up* one, triggered and supported by the purchasing power of young and informed generations; (ii) a *top-down* one, which refers to governmental polices and regulations, imposing compliance on businesses and their investments; and (iii) a *reputational* one, whereby a business decides to become more sustainable to wash away past stains.

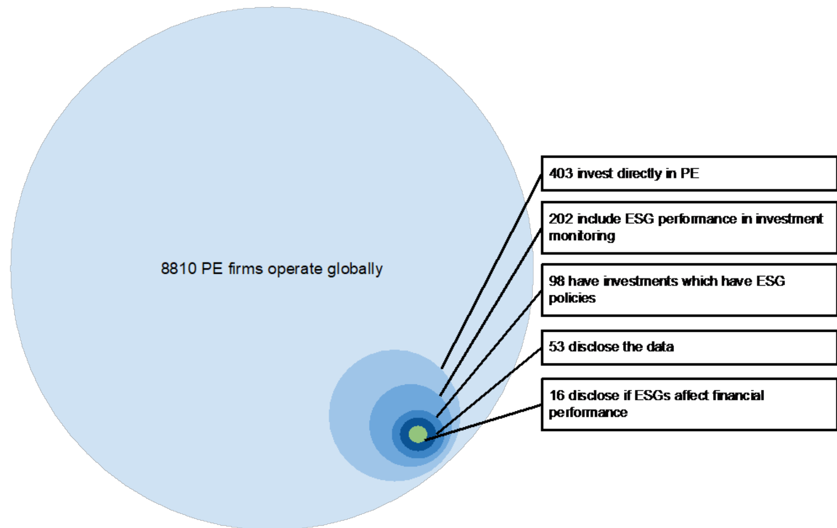
According to UBS Group (2018), 65% of investors believe in "helping to create a better planet" and say this has a strong influence on their spending, lifestyle, and career decisions. However, 65% of investors does not equate to 65% of capital. According to EY (2020), 80% of CEOs believe that governments, businesses, and society will reward companies which take "meaningful action" in the next five to 10 years. In 2021 PitchBook, the online data platform dedicated to PE, found that 95% of limited partnerships were "already evaluating" or planning to "increase their focus" on ESG risk factors.

These insights highlight a clear trend in the market beyond the existing anecdotal evidence. Yet the trend could be characterized as developing in slow motion. Numbers can easily be inflated or manipulated to bring home a point that may not truly reflect reality. Pucker K. and Kotsantonis S. (2020) highlight this in a paper where they unveil the true impact PEFs have on ESGs and call it a "PE-ESG Bubble" (see Figure 1).

Pucker K. and Kotsantonis S. (2020), argue that numbers demonstrate the discrepancies between what is being declared and what is truly happening behind the scenes. Therefore, the evidence of a shift towards an ESG and PE partnership cannot only be based on the fact that the market may be trending in this direction.

More concrete reasons of the shift to sustainability that many authors identify related to two major factors: (i) the purchasing power of millennials and the Gen-Z cohorts born since the early 1980s and (ii) supernational, international and national legislation.

Figure 1. Figure 1: Representation of the "PE-ESG Bubble". Adapted from Pucker K. and Kotsantonis S. (2020)



The literature seems to concur on the fact that regulatory imperatives are further advancing ESG initiatives. Regulatory bodies are starting to push for sustainability and ESG-compliant behaviors in all aspects of business. The EU, for instance, requires a wide range of "financial services participants" to disclose ESG factors and reporting requirements (Lapham, K., et al., 2021). These regulations have introduced a new level of transparency for the asset management sector and apply to EU fund managers and financial advisors, as well as other non-EU funds which market their funds in the EU.

Another motive for embracing ESG is to improve the generally 'bad reputation' that PE firms have. The debate about whether PE is intrinsically bad or simply needs better PR is ongoing. However, the literature hints at the fact that taking the industry in an ESG direction could be the reputational redemption that PE firms require to ease the potential pressure they may face in future for tougher legislation.

Advantages and challenges of the ESG transition

There are several reasons why PE could facilitate the transition towards sustainability better than other financial institutions or tools:

- PE and VC have a unique position in the financial system because they precede bank

loans and capital markets as the first source of investment for many firms. Therefore, PE can identify and gain access to younger and more innovative firms five to 10 years before they are ready to hit public markets (Loiacono S., 2021).

- PEF do not have strict regulatory requirements and have a far smaller pool of stakeholders compared to other financial institutions, which allows them to be more flexible with their investments, thus making them far better candidates to finance and buy the equity of smaller and younger ESG-compliant firms.
- Successful PEF know how to implement 360-degree management at a company and often restructure management in order to improve efficiency, reduce costs and enhance synergies (Barber F. and Goold M., 2014).

Pucker and & Kotsantonis (2020) identify the holding period of PEF as the first obstacle to more PEF getting involved in ESG: the median holding period of a company in a PEF's portfolio is 4.5 years. Sustainability challenges are usually addressed and solved over longer periods of time and require investments that pay off in the medium to long-term.

They also highlight the difficulty of quantifying the value of ESG investments. An investment, like the purchase of higher quality water filters, is relatively straightforward to quantify. However other initiatives are far more difficult to measure, such as striving towards gender balance in upper management or investing in animal rights monitoring at an overseas farm.

The third obstacle to the progress of ESG in PE relates to sustainable finance in general, where there is a lack of standardized ESG definitions, measurements, and regulations.

Finally, the size of companies backed by PEF is far smaller than the average publicly traded company (Pucker K. and Kotsantonis S., 2020). This puts smaller firms at a disadvantage as they might not be able to access the same resources and expertise as larger companies to help them build solid sustainability records.

Value creation is a central theme to this paper as it is the measuring stick against which the success of ESG factors is assessed. According to PwC (2018) the private equity industry is now a mature market and is in a third wave defined by the "requirement to pull on a full suite of value creation levers in every asset to achieve its full potential". PwC outlines how firms can reach their potential through a "holistic" approach which looks at: i) operational performance; ii) improving strategic capabilities; and iii) effective capital management.

The eight ways in which ESG factors drive value creation in firms held by PE

McKinsey's report (McKinsey, 2020) identifies "top-line growth" as the first way that ESG creates value. Top-line growth is achieved through attracting more B2B and B2C customers with the proposition of more sustainable products and achieving better access to resources through stronger community and government relations (Henisz, 2020) (McKinsey, 2020).

According to McKinsey the second way for ESG to create value in businesses is through "cost reduction". Cost reductions can come about through better sustainability practices; for instance, reducing water usage and electricity for sustainability reasons will reduce costs, all other factors remaining equal.

"Reduced regulatory and legal interventions" is the third way for ESG to create value according to McKinsey. Strength in ESG helps reduce "companies' risk of adverse government action" across multiple sectors and locations. McKinsey calculated that on average one third of corporate profits are at risk from state intervention. However, some industries are more impacted than others; for example, the banking system sees 50-60% of its EBITDA at stake.

McKinsey's fourth way for ESG to create value is "productivity uplift". EY highlighted a similar reason for "why" PEF should "embed purpose and transparency" in its strategy namely, "to win the best talent". (Although EY's definition of "purpose and transparency" is not clearly stated, references to ESGs are numerous.)

McKinsey's fifth and final way for ESG to create value is through "investment and asset optimization". For example, firms should avoid investments that may not pay off because of longer-term environmental issues, such as huge write downs of oil tankers. An ESG proposition could also enhance investment returns by allocating capital to more promising and more sustainable opportunities.

Indahl and Jacobsen (2019) identify cases in which the public and regulatory attention received by the industry in recent years has come to be viewed as the model for best-in-class ESG practices. They add that "this reputation is giving it a strong competitive edge, allowing it to grow market share and demand premium rates for its high-quality services." McKinsey uses competitive advantage as an example of a negative consequence of not investing in asset optimization: firms may "fall behind competitors that have invested to be less 'energy hungry'."

EY adds another reason why it is important to embed purpose and transparency in PEF strategy: "to meet the demand of LPs" (also known as investors in the PEF itself).

Indahl and Jacobsen (2019) state

that their fund assesses "how the situation in the world at that point is affecting the value and performance of our companies". Regarding climate risk, "companies face a significant ancillary potential risk".

The opinion of PE managers

To substantiate the arguments of the paper, the author decided to include focused, in-person in-depth interviews with PE managers to gather more detailed, first-hand information on the above. Interviews were conducted with four funds investing and receiving funds predominantly in Europe, and a private capital association to which they all belonged.

The interviewees' details are in Annex 1. For privacy reasons, the names of the funds and managers interviewed have been redacted.

In particular, these interviews explored the following questions:

1. To what extent does your fund view ESG factors as a means to create value, both in the fund itself and in the firms you invest in?
2. According to the literature, ESG considerations can create value through one or more of the following ways. Could you identify which of these factors you have taken into consideration when investing in a company?
3. Have any of the following ways proved to have created value for one or more company you exited?
4. In the context of ESG, which do you consider to be sound and adequate for future transactions as ways to create value, out of the listed factors?
5. In the context of ESG, do you consider other factors as drivers of value creation which have not been listed above?

Factors taken into consideration are the ones identified through the literature review and described above: 1. Top-line growth; 2. Attracting the best talent; 3. Reduced regulatory and legal interventions; 4. Improved efficiency and cost reductions; 5. Competitive advantage; 6. Risk management; 7. Meeting the demand of LPs; 8. Investment and asset optimization.

The view that ESG is either flooding into the PE sector or is already present is evident in the literature and was articulated strongly by all the interviewees. The "last few years" (indicatively 2019-2022) timeline was highlighted by multiple interviewees who noted that the emergence of ESG has accelerated and recently became essential to their activities.

The relevance of ESG to the fund

The importance of ESG is reflected in the answers to the first question, where all but one respondent saw ESG as important factors to create value.

In general, the respondents underlined the following:

- Governance is at the core of what PE is and does. PE firms pay particular attention to social and governance aspects (and this was seemingly true even before the emergence of ESG criteria).
- Some firms make the "E" part of ESG their reason to exist as a business.
- Other firms are starting to orient themselves towards environmental sustainability, primarily because there is pressure from numerous stakeholders. This includes finding areas that can be improved such as using more recycled materials in the production line and using self-generated electricity in warehouses.
- ESG requires resources; for instance, in smaller funds, it is common for the budget not to provide for an individual who is solely dedicated to the ESG cause.
- Most firms are still refining their ESG approach because they only launched an ESG fund recently.
- Value Creation through ESG is a product of correlating social value and finance, meaning that while there must be an ESG performance, the financial returns must not be forgotten.

Factors considered when investing in a company

On the second question, while replies varied, only risk management was selected by all the interviewees as a way to create value.

Some key points emerged from different answers to this question. In particular:

- According to one respondent competitive advantage is determined by three main factors: 1) continuous innovation; 2) international growth potential; and 3) total growth potential. ESG therefore is less of a determining factor, and it only becomes one if it is "integrated into the innovation process of funds".
- According to another respondent "top-line growth" is not the reason why his fund looks at ESG. As the only fund interviewed which specializes in consumer products, the assumption that they would be focused on top-line growth by connecting consumers with ESG values was unfounded. In this regard, his answer may seem counterintuitive.
- On "attracting the best talent", a respondent used the example of how the implementation of gender balance in firms allows the business to be "more credible". Gender balance was seen as a simple way of demonstrating to investors, clients, and the market at large the commitment to ESG.

- A respondent noted that risk management was very important in the due diligence phase.
- One respondent excluded "investment and asset optimization" because "in the short term one needs to invest further or increase the company's debt which could lead to a sub-optimal impact on the company in the short-term".
- All funds agreed that "investment and asset optimization" were not taken into consideration when investing in a company.

Effective ways to create value

This question should be taken with a grain of salt, because many of the funds interviewed have not yet exited or are still in the process of exiting from their more ESG-focused investments. This is in line with the "last two years" timeline provided by them, because most PEF hold their assets for longer than two years.

Several points emerged from interviews on this question:

- When it comes to exits, "improved efficiency and cost reduction" are very important because they affect both costs and EBITDA, which is often used in multiples to demonstrate value creation.
- "Top-line growth" and maintaining it at a high level are also important to demonstrate during the exit phase. As with cost reduction, topline growth has a direct effect on the calculation of EBITDA.
- During the exit phase investors have already provided the capital for the investments so what they care about is the return. However, what may also be useful for funds is to see how much buyers appreciate the value created by ESG, which can then be used to retain and attract investors for future rounds of funding.
- During the exit phase, satisfying the limited partners is often not an important factor.
- "Keeping up and being ahead of regulatory developments and reducing legal interventions", "competitive advantage" and "risk management" create value during an exit.
- Adherence to ESG criteria usually implies increased spending, hence further debt which precludes the optimization of assets and investments.

It is worth noting that an Italian fund for alternative investments also highlighted "competitive advantage" and "improved efficiency and cost reduction" as features of its exit strategies. The head of ESG added that what was very much appreciated in two recent exits was the start of an ESG process and related know-how in the firms, even though the process was not complete. This goes to the core of PE as both a way of investing and a means to build management

structures that can make the firm more profitable, long after the original fund invested in the firm.

The ways ahead

The fourth question aimed at exploring what these experienced managers envisioned for the future of ESG and PE. They made the following points:

- Factors relevant for the future of the industry are "top-line growth" and "attracting the best talent".
- In terms of top-line growth, there is still some work to do on how to best harness the ESG message to truly exploit it and see it become a common feature in top-line numbers.
- Some respondents would like to see more firms that can really exploit ESG factors for their top-line growth. Thus, firms that position themselves in the market from the start as ESG-compliant can benefit from the growing trends towards sustainability and circular economies.
- Such firms are very important for the future, because they will be exploiting the rising global trend towards greater sustainability seen in recent years, which in turn could give them exponential growth prospects.
- Improved efficiency in the long run will not be a crucial element of ESG investing.
- ESG may imply increases in costs to meet future ESG standards.

Other factors

The fifth and final question was: "In the context of ESG, do you consider other factors as drivers of value creation which have not been listed above?". The most common response was related to the "Governance" aspects of ESGs. It was noted that:

- The main job of PEFs revolves around the establishment of proper governance in the firms that funds invest in. PEFs work with firms to build a better board of directors with independent directors. They also create incentives and alignments between shareholders and managers. From this point of view PE "has always been best in class".
- Historically there has been little focus on some aspects of the "social" factors, such as diversity and "work-life balance", which have not been considered important.
- Creating more diverse boards of directors allows firms to: (i) Avoid *faux pas* which could negatively impact reputations and revenues; (ii) incorporate all cultures; and (iii) eliminate blind spots.
- Attracting consumers that are more ESG conscious can boost the top line and improve a brand's image.

- Results can extend this to improve the brand image and reputation of the firms in the portfolio, thus increasing the intangible assets.

Preferences and the importance of governance

The ways to create value through ESG that were most commonly selected across all three of the relevant questions were: (i) competitive advantage and (ii) risk management. Both are quite broad and mature concepts in the financial industry: risk management affects all industries and, likewise, for all industries competitive advantage is essential to survive. In addition, because these concepts are not new, the managers interviewed were familiar with them and dealt with them before they were also relevant for ESG. While it is encouraging to note that these concepts are recognized by the industry, the author believes that in the coming years, as the ESG "avalanche" affects markets, other ways will have to be also widely explored in order for PE firms to achieve the same degree of success in creating value through ESG as they currently do using the two ways that interviewees most frequently cited.

The least commonly selected way to create value through ESG was "investment and asset optimization". The lack of information about it in the literature review, and the shortage of managers willing to select it as a viable option, confirms in the author's view that this was the least robust approach to leverage ESG for values creation. This, however, does not mean it cannot be a valuable leverage tool for specific firms.

A crucial finding of this paper is the lack of importance placed in the literature on PE's strength as a market leader in governance. This not only emerged from the respondents' replies but was the most highlighted subject during the ensuing discussion with interviewees. As the literature review revealed, E, S and G together make up what is commonly defined as the sector's "sustainability". Because by its nature PE is a market leader in governance, the next steps should be to use this competitive advantage to improve the industry's performance in relation to the environmental and social pillars.

Interviewees also agreed that various ways to leverage ESGs can be more or less powerful in creating value, depending on the phase of the investment cycle. This is clearly visible in the importance attributed to "meeting the demands of limited partners" in the question relating to "investing in a company". Only one fund selected this category regarding the reason why it exited an investment.

Conclusions and recommendations

Based on the literature review and the interviews, this paper has reached the conclusion that ESG is increasingly and exponentially

gaining ground in the PE world. The PE industry is in its "fourth iteration", with the increased attention to ethical and sustainability factors accelerated by the COVID-19 pandemic. This is not only due to the injection of liquidity by central banks during the pandemic but also to a newly found social conscience shared by many people who have been impacted by the consequences of COVID-19.

Additionally, many PE firms, particularly smaller ones, have been challenged by new EU disclosure regulations which have forced them to develop new tools to measure and disclose ESG investments. Due to their size and budget, it has become increasingly difficult for them to compete with larger firms which have much bigger teams that are dedicated to ESG.

Given the analysis above and the results of the interviews, the author makes the following recommendations for the industry to better seize the opportunities offered by ESG to create value.

Welcome both the bottom-up and top-down approaches

When it comes to sustainability, it is important that the demands of a younger generation that is well-informed about ESG are addressed using effective legal and policy tools for the transition to be effective in ensuring the PE industry's ESG compliance. This challenge is of course not unique to PE. Sustainable development policies are agreed at an intergovernmental and national level to advance various sectors, but they can only be effective if welcomed by communities and the targets of the policies themselves. In the specific case of PE, given the demand of ESG investors to make money while doing good, regulatory frameworks are essential to move the industry in the right direction in a consistent and coordinated way.

Develop know-how and expertise in E and S

The PE industry has been at the forefront in pressing for better corporate governance since the industry's emergence in the 1980s. In order to be fully sustainable by equally addressing environmental and social matters, the industry must continue to be a market leader in governance. However, its weaker spots remain in ascending order, S and E, which should be dealt with in more depth by experts in these respective fields. The author thus believes it is important for the PE industry to look to recruit specialized talent in these two sustainability subsets in order to build the know-how essential for the latest PE 4.0 phase that the industry faces.

Reputational redemption

The opportunity ESG presents the PE industry for improving its reputation is unmatched. The author believes the industry cannot miss this opportunity and therefore recommends that it should fully embrace the ESG trend. A better reputation can be acquired in

many aspects of a business, from less financial pressure to comply with new legislation to greater appreciation of the company's merits by the public at large.

Embrace the power of market dynamics

The concept of supply and demand can be leveraged by the industry to create an ESG-friendly world. PE and VC are a source of capital for many firms in all industries and are often trend setters. If the PE industry focused primarily on ESG investments, it would help squeeze firms that do not comply with ESG standards out of the market. This would encourage even more innovation by ESG-compliant firms in all industries, while potentially creating a new type of "vulture financing" where PE firms specializing in ESG investments sought to turnaround distressed firms by implementing ESG standards.•

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Annex 1: Summary of the interviewees and their respective funds

Source: Based on information available at www.aifi.it

Manager's position (and Seniority)	Fund/Association	AUM/N° of members*	Sector*	Geographical Preferences*	Investment size *
Secretary General	European Private Capital Association	155 members	n.a	Primarily EU, ROTW too	n.a
Managing Partner	Leading Consumer Growth Fund	$28 billion globally, €1.2 billion handled by manager interviewed	Fashion, Food and beverages, Furniture, Healthcare, Retail, Luxury	Manager interviewed focuses on EU, fund itself is global	Investment: €25 - €100 million
Managing Partner (most senior in fund)	European fund investing in mid-market Italian export-led businesses	€195 million	High value-added industrial goods' sectors, non-cyclical businesses, as well as pharmaceuticals, chemicals, and certain consumer segments such as luxury and food	Italy and DACH region (Germany, Switzerland, Austria), Asia	Investment: €10 - €25 million Revenues between €20 - €100 million
Investment Director	Independent Finical Group specialized in Alternative Investments	€ 810 million	Agriculture, Biotech, Chemicals and materials, Energy and environment, Food and beverages, Industrial products and services, other Manufacturing, Retail	Italy, EU	€ 0.5 – € 30 million
Head of ESG	Italian Fund Alternative Investments in PEF	€ 2.5 billion	Fund of funds, Agriculture, Energy.	Italy, EU	

Not Good Enough: Efforts to Support Ethical Corporate Purpose

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Finalist

Fatjon Kaja
Albania
PhD Sutdent, University of Amsterdam, Amsterdam (The Netherlands)*

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

"… *A wise man once said that you should never believe a thing simply because you want to believe it.*" – Tyrion Lannister, Game of Thrones

In an era dominated by the pressing concerns of climate change and sustainability, the notion of corporate purpose has become a battleground of opinions. Academic research on corporate purpose has sprouted like mushrooms after rain, creating a cacophony of arguments and theories (Bainbridge, 2020). Anecdotal evidence is even worse, with public opinion questioning the moral responsibilities of corporations with such vehemence that it rivals the intensity of religious zealots. Often mixed with a strong dosage of activism, doomsday scenarios are becoming the go-to point, unless corporations are held responsible for their impact and take immediate actions to address the climate crisis. Or so the story goes.

Easier said than done. The road to corporate responsibility is paved with complexities and contradictions that deter progress. Even those who agree that action should be taken find themselves entangled in fierce debates over the degree and the mechanisms of such action. The parties bicker and squabble with one another with the same fervor that they agree with the following statement: *whatever corporations are doing, it is not good enough and they should be doing more.*

In and of itself, the statement does not pose an ethical issue. After all, the public is entitled to its normative views in a democratic society. Yet the relentless tendency to expect corporations to do more

is fueling ethical considerations, with greenwashing emerging as the most prominent issue. Defined as "the selective disclosure of positive information about a company's environmental [...] performance without full disclosure of negative information [...], so as to create an overly positive corporate image," greenwashing poses serious ethical concerns (Lyon and Maxwell, 2011). By misleading consumers into believing that they are making an environmentally friendly choice, companies not only deceive consumers who may be making decisions based on these claims, but also risk undermining the credibility and progress of genuine environmental efforts. The lack of regulatory frameworks to monitor and sanction greenwashing activities exacerbates this problem, reflecting the urgent need for action.

This essay explores historical and economic perspectives on corporate purpose, unravels the deceptive practices of greenwashing, and scrutinizes the ethical implications at play.

Corporate Purpose: A Historical and Economic Perspective

Distilled to its core, corporate purpose refers to the fundamental reason for the existence of a corporation. In the early history of corporations, particularly during the Roman and Middle Ages, such a reason was easier to ascertain, as corporate charters were often granted for a specific duration or purpose, given "the lack of legal means to commit capital for the long term" (Dari-Mattiacci et al, 2017). Once the stated purpose of the corporation was fulfilled or the specified period of time had elapsed, the corporation would be dissolved. This limited duration or purposeful nature of corporations was common at the time. It reflected the understanding that corporations were established for a specific undertaking and were not intended to exist forever or engage in activities indefinitely.

The nature of political systems during the Renaissance and the Age of Enlightenment helped maintain this status quo. Corporate charters were difficult to obtain or not appealing enough, as they were dependent on the whims of kings, who were too often suspicious of plots or who completely disregarded previous charter arrangements (Holdsworth, 1922; Scott, 1912). Hence, there was a tendency to grant charters for "noncommercial" endeavors. Indeed, most of the early English corporations were primarily utilized for municipal, ecclesiastical, charitable, and educational purposes (Seavoy, 1982).

As the Age of Exploration led to the discovery of new lands and profitable trade routes, the notion of "profit-driven" corporations emerged (Acemoglu, 2005). The need to lock in long-term capital to sponsor voyages around the globe spurred legal innovation, which helped

the rise of business corporations during the 17th century (Dari-Mattiacci et al, 2017). Part of the reason why governments accepted this legal innovation was that the newly established corporations still fulfilled some sort of public purpose. For example, in the case of the Dutch East India Company – the classic example used to show the emergence of the corporate form – the corporation used its "pooled resources to contribute to the military advancement of Dutch interests overseas through various infrastructure investments" (Dari-Mattiacci et al, 2017). Such practices started to become the norm throughout Europe. In his comprehensive analysis of English corporate law, *Treatise on the Law of Corporations* (1793), Stewart Kyd defined corporations specifically as «bodies politic» and identified their purpose as serving public or quasi-public infrastructure needs (Guenther, 2019).

Building on the English tradition, early American corporations were founded on the basis of a strong sense of community, with their primary purpose being the betterment of society as a whole (Handlin and Handlin, 1945; Hilt, 2014). As business corporations were relatively scarce and insignificant during this period, they were often viewed as serving public or quasi-public infrastructure needs rather than pursuing purely private interests (Hamill, 1999; Blair, 2013).

The concept of corporate purpose continued to evolve in the 19th century, as corporations became dominant in the United States. Tracing the historical development of corporate purpose reveals a shift from corporations primarily serving public or quasi-public infrastructure needs to a greater emphasis on the maximization of private profit, exemplified by the landmark case of *Dodge v. Ford Motor Co* (1919). This ruling asserted that a corporation's primary purpose was profit maximization, subordinating other objectives, including social responsibility (Fisch, 2021).

A century later, such thinking is still pervasive. (Mitchell, 2019; Bainbridge, 2022). As a matter of fact, most corporate charters today do not specify the purpose of the respective corporation but instead state something along the lines that the corporation will engage in lawful activities (Fisch, 2021). One might therefore think that the debate on corporate purpose is settled, but periodic corporate scandals such as Enron have shocked the public's conscience and kept the debate going (Bratton, 2002).

In fairness, scholars have adopted different perspectives on corporate purpose. The Nobel laureate Milton Friedman argued that the sole responsibility of a corporation is to generate profits for its shareholders (Friedman, 1970). This perspective is often associated with the shareholder primacy theory, which asserts that

corporations should prioritize the interests of shareholders above other stakeholders (Bainbridge, 2020; Bebchuk and Tallarita, 2020; Berle, 1931; Black and Kraakman, 1996; Easterbrook and Fischel, 1991; Hansmann & Kraakman, 2001; Jensen, 2002; Van Der Weide, 1996).

Other scholars have argued that other stakeholders' interests should be considered, including employees, customers, and the community, rather than solely focusing on shareholder value. For example, the leading legal scholar Lynn A. Stout has emphasized the importance of considering the interests of all stakeholders in corporate decision-making and advocates for a more inclusive view of corporate purpose (Stout, 2012). This perspective aligns with the stakeholder theory, which suggests that corporations should consider the well-being of all who are affected by their actions (Dodd, 1932; Edmans 2020; Fisch, 2021; Freeman, 2010; Mayer, 2016; Ripken, 2009; Stout, 2003; Williams and Conley, 2005).

Such divergence and robust debate can be explained in part by the fact that the discourse surrounding corporate purpose lacks clarity and empirical evidence (Spamann and Fisher, 2022). As there are various interpretations and limited data to support the theories put forward by different stakeholders, there is a lack of consensus, which contributes to a noisy environment where competing narratives are perpetuated, often without a strong foundation in facts.

Amid this lack of consensus, ethical concerns surrounding corporate purpose take center stage, with greenwashing under the spotlight.

Greenwashing: Deceptive Practices and Consumer Influence

Climate change is an inconvenient truth (Gore, 2006). Heeding the advice of scientists, governments all over the world are taking measures to help reduce their respective countries' carbon footprint. Take, for example, the US Inflation Reduction Act. Passed in August 2022, it is arguably "the most significant legislation in US history to tackle the climate crisis" (White House, 2023). Yet regardless of such valiant efforts, it is safe to say that governmental endeavors alone will not solve the climate crisis (Tirole and Bénabou, 2010). As such, there has been a lot of public and governmental pressure on companies to implement a "net zero" transition when it comes to their respective carbon emissions (Gözlügöl and Ringe, 2023).

In response, numerous companies have begun to advertise their greenness (Edmans, 2022). This growing trend has paved the way for greenwashing—a deceptive practice where companies misrepresent their environmental impact or the environmental benefits of their products (Delmas and Burbano, 2011). Notable instances of greenwashing have exposed the dissonance between a company's messaging and its actual

practices. In 2010, Chevron launched the «We Agree» campaign, which aimed to highlight the company's commitment to finding clean and renewable energy solutions. However, critics perceived it as an attempt to distract from Chevron's environmental controversies, including oil spills and ecological damage, underscoring the gap between rhetoric and reality (Cherry, 2013). The 2015 Volkswagen «dieselgate» scandal, where the company manipulated emission tests to present false environmental compliance, further illustrates the deceptive nature of greenwashing (Boston, 2017).

Consumer demand plays a pivotal role in driving greenwashing practices (Delmas and Burbano, 2011). As more individuals prefer more sustainable investments, companies vie for a share of the market (Bauer, Rouf, and Smeets, 2021). With consumers exerting pressure on companies to appear environmentally friendly, incentives arise for positive communication about environmental performance. Paradoxically, the very consumers pushing for greater environmental accountability may inadvertently fuel the deceptive practices they seek to combat. Nonetheless, this manipulation of consumer perceptions raises significant ethical considerations.

Scholars have long argued that businesses bear an ethical responsibility to provide accurate and reliable information, enabling consumers to make informed choices based on genuine environmental considerations (Orts, 2017). Greenwashing subverts this principle, eroding trust and violating ethical principles of honesty and transparency. Furthermore, greenwashing undermines the autonomy of consumers by exploiting their goodwill and desire to support environmentally responsible companies.

Equally worrisome is the fact that, by diverting attention and resources away from genuine sustainability initiatives, greenwashing impedes progress towards addressing pressing environmental issues. The false sense of progress it perpetuates obstructs real efforts to reduce environmental harm and stifles the growth of authentic sustainable businesses. It is not far-fetched to imagine startups with promising environmentally friendly products that do not get any funding or market share simply because another better-established company exaggerated its own environmental footprint, thus attracting all investors or consumers, who were falsely led to believe that the product was legitimate from the start. While the better-established company increases its odds of running into its own "dieselgate" scandal five to ten years in the future, that does not change the fact that the odds of the startup surviving for this long are slim to none.

When it comes to the regulation of greenwashing, it remains limited, with uncertain enforcement measures.

Recent legislation aims to rectify the situation (European Commission, 2023). Scholars have studied such legislative efforts, highlighting their positive impact and their shortcomings (Pacces, 2021; Armour, Enriques, and Wetzer, 2021). Yet the fact remains that this regulatory vacuum creates an environment conducive to deceptive practices, as companies face minimal punitive consequences for engaging in greenwashing. The absence of robust frameworks to monitor and sanction such activities amplifies the urgency for effective action.

While formal regulation may be lacking, informal monitors such as activist groups, non-governmental organizations (NGOs) and the media play a crucial role in exposing and challenging greenwashing practices. The vigilance of the public becomes paramount in holding corporations accountable. In the absence of robust regulatory frameworks, public scrutiny becomes a crucial factor in curbing greenwashing. But, with a public, imbibed entirely by its own (often unrealistic) desires and expectations for sustainable products, one wonders whether this is a question of «*quis custodiet ipsos custodes*?"

Ethical Considerations

To deepen our understanding of the ethical quandaries surrounding greenwashing, notable philosophers such as Aristotle, Kant, and Mill provide valuable insights. Their ethical frameworks provide a lens through which the ethical implications of deceptive corporate practices can be analyzed and suggest abundant points for reflection for the public and for corporations.

Perspectives from Aristotle

At its core, Aristotle's virtue ethics emphasizes the cultivation of moral character and the pursuit of *eudaimonia,* or flourishing. To attain *eudaimonia*, one must be fervently dedicated to a virtuous life, with the individual striving to excel every day to bring out what is the best in him or her. According to Aristotle, the well-being of the individual and the *polis* – the society to which one belongs – are closely intertwined; the larger community determines what virtuous endeavors are. Indeed, the good of the *polis* supersedes the "good life" of any individual separately (Solomon, 1992). As such, ultimately, there is no split between private self-interest and the greater public good; either both benefit from the individual having lived a virtuous life or, if not, then one has not lived a virtuous life to begin with.

From an Aristotelian perspective, greenwashing represents a deficiency of character, as it involves deception and a disregard for the well-being of others. When companies portray themselves to be something that they are not, they are violating the basic principles of honesty and fairness of the Aristotelian virtuous life. Furthermore, the fact that most of the companies are engaged in greenwashing to increase their market share or their revenues from

sales would have seemed even worse for Aristotle. It signals a weak and corrupt personality, as a virtuous person avoids displaying self-indulgence in general, let alone one that is attained in dishonest ways. Genuine environmental efforts, on the other hand, exemplify virtues such as honesty, transparency and environmental stewardship, promoting the collective flourishing of society, something that Aristotle would have deemed an honorable endeavor worth pursuing.

Perspectives from Immanuel Kant

Immanuel Kant's deontological ethics centers on the principle of treating others as ends in themselves and upholding moral duties. According to Kant, the pure idea of duty is the cornerstone of an ethical life; one must do something solely because it is the right thing to do (Altman, 2007). This categorical imperative is the metric of ethical behavior and the key to happiness. Individuals are to seek happiness (*Glückseligkeit)* only through forms of what is deemed to be morally worthy behavior (*Glückwurdigkeit*) (Dierksmeier, 2013). A given conduct qualifies as morally worthy behavior only if it can be universalized as a norm.

From a Kantian perspective, greenwashing violates the Kantian imperative of truthfulness and respect for individuals. By deceiving consumers and manipulating their choices, corporations treat them merely as a means to an end, undermining their autonomy and dignity. Furthermore, Kant's formula of universal law fundamentally clashes with deceptive business practices, so such practices should be abolished (Altman, 2007). Greenwashing, as a deceptive business practice, cannot be universalized; if all companies started to engage in greenwashing, the public would not be able to estimate the real intrinsic value of companies. Indeed, if every corporation engaged in greenwashing, then the whole purpose of engaging in greenwashing would disappear, because potential benefits from it would be severely diminished, if not eliminated entirely. Such an outcome would be undesirable and self-undermining, so, as a matter of morality, corporations should not pursue it. Genuine environmental initiatives, on the other hand, align with Kant's ethics by upholding honesty and respect for individual decision-making.

Perspectives from John Stuart Mill

Utilitarianism, championed by John Stuart Mill, focuses on maximizing overall happiness or utility. The key component of utilitarianism is the maximization of utility or the happiness of the greatest possible number of people. Unlike Aristotelian or Kantian ethics, utilitarianism has a consequentialist perspective; the intentions of the action are irrelevant, as its outcome is paramount (Renouard, 2011). Given this, utilitarianism can be

unpredictable when it comes to consistent or precise outcomes on the same issue; the final answer on the morality of the action depends on the outcome. Hence, it is not farfetched to imagine scenarios where utilitarianism allows for the prevalence of profit-making over individual well-being or human rights, if profit-making can generate the greatest overall happiness.

In the context of greenwashing, a utilitarian analysis leads to two scenarios. Under the first scenario, the deceptive practices employed by corporations yield short-term gains but can result in long-term harm to the corporation, if exposed. While appealing in the short-term, this approach should be seen as undesirable, as it can have a major impact on the potential future income of the corporation (Singh, Inglesias, Batista-Foguet, 2012). Under the second scenario, deceptive practices employed by corporations yield short-term gains for the corporation but long-term harm to society. The harm inflicted upon consumers, the environment, and the progress of genuine sustainability efforts outweighs the immediate benefits that any firm can gain by engaging in greenwashing. This can be easily illustrated; if you add the pre-tax income of the ten leading companies in the world for 2022, you arrive at a total of $977.24 billion (Szmigiera, M. (2021). Even if one were to assume generously that greenwashing might double the pre-tax income of these ten leading companies, that would amount to just a fraction of what is needed to fight climate change (United Nations, 2022). Genuine environmental initiatives, driven by transparency and a commitment to lasting change, align better with utilitarian principles by promoting the greatest overall happiness and well-being.

Concluding remarks

The rise of greenwashing poses significant ethical challenges in relation to the pursuit of corporate responsibility and sustainability. As consumers push for greener products and services, companies face the temptation to exaggerate their environmental commitments, perpetuating deceptive practices. This in turn undermines consumer trust, impedes genuine sustainability efforts, and erodes the credibility of corporate purpose.

The philosophical perspectives of Aristotle, Kant, and Mill shed light on the moral dimensions of greenwashing, emphasizing virtues, duties, and the overall well-being of society. By understanding the roots of corporate purpose and the ethical quandaries it presents in holding companies accountable, society can work towards fostering genuine environmental progress and a more sustainable future.

The latter can only be accomplished through an informed and vigilant consumer base. If not, as the saying = goes, “be careful what you wish for.”•

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The European Central Bank and the Future of Ethical Debt Market

Ethics & Trust in Finance
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Finalist

Joanna Anita Pękala
Poland
Bond Trader
*Nordea Markets**
Copenhagen (Denmark)

The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

When assuming the position of President of the European Central Bank (ECB), Christine Lagarde decided to perform a strategic review of monetary policy as one of the first objectives of her term. The review aimed to take account on the ECB's agenda of the social and climate challenges faced by European society. According to Lagarde, the ECB should join forces with European institutions to counteract the threats of the 21st century, such as climate change and social inequality. This is because financial markets bear joint responsibility for building a sustainable development economy that reconciles economic interests with social responsibility.

Social responsibility is something relatively new when speaking of financial markets. Markets have always been a place for raising capital and maximising profits at some acceptable level of risk. The realisation that there is an ethical dimension to the activities of market actors, where acting for the higher and general good may conflict with financial self-interest, testifies to significant qualitative changes in the world of finance. These changes are all the more meaningful because ethical reflection on the activities of market actors is not only stimulated by mounting social pressure for qualitative changes, but also because the actors themselves are increasingly aware of the need to encourage financial institutions to engage in global efforts to promote sustainable development.

This increased awareness among investors, who are more and more interested in how the capital they lend will be used, indicates the

emergence of an ethical debt market. Their involvement in the promotion of a sustainable economy puts an extra pressure on issuers to use the funds obtained in a socially responsible manner. Ethical debt instruments raised in this way oblige issuers to spend their loan facilities on objectives which are socially or environmentally positive for society. Thus, the benefits of such instruments are reaped not only by investors in the form of coupons, but also by the whole of society; for example, by enjoying cleaner air or better access to education.

The market for ethical debt securities has gained momentum in recent years. The green bonds market is by far the most popular, with a total value of issued bonds exceeding $1 trillion in 2020. Among EU countries, Poland was the first to issue green bonds. Soon other countries followed, including France, Belgium, Lithuania, Ireland, the Netherlands, Hungary and Germany. Another ethical debt instrument is sustainable development bonds. Funds raised from these instruments are allocated in accordance with the United Nations Sustainable Development Goals (SDG) which aim to achieve "a better and more sustainable future for all". These goals include, for example, clean water, education, and climate action. Ethical debt instruments also include ESG bonds, where the issuer undertakes to spend the acquired capital to promote the environment, social responsibility and corporate governance; blue bonds, intended to finance projects aimed at saving aquatic life and water quality; vaccine bonds, supporting the distribution and promotion of vaccines to help prevent mortality in children up to five years of age. In addition, there are many other bonds devoted to financing "local" ethical goals: for example, Tobacco Control Social Impact Bonds, which support Zambian farmers in transition to alternative crops; Rhino Impact Bonds, which finance the protection of endangered species; and Youth Employment Bonds, which support employment programmes for young people unemployed for at least one year.

The ECB as a bond market actor

In recent years, central banks have become the key actors in the debt market, running bond purchase programmes all over the world. In Europe, the ECB has launched the Asset Purchase Programme (APP) to purchase debt securities on the secondary market. The securities purchased are issued both by state treasuries within the euro area under the Public Sector Purchase Programme (PSPP), and by the private sector under the Corporate Sector Purchase Programme (CSPP), the Asset-Backed Securities Purchase Programme (ABSPP), and the Covered Bond Purchase Programme (CBPP). The PSPP constitutes the largest part of the APP, representing more than 80 per cent of the total market. Originally intended to be only a temporary instrument for extraordinary

interventions, the APP has become a permanent tool of the ECB's monetary policy, alongside such standard instruments as interest rates or open market operations (OMO).

Under Christine Lagarde, the ECB has declared its readiness to help combat climate change. The bank conducts economic analyses to assess the impact of climate change on the stability of market prices and the financial system, and monitors how the euro zone banking sector manages climate risks. These initiatives are supposed to accelerate the identification of threats that climate change may inflict on the financial system. On 25 January 2021 Lagarde announced the appointment of a special internal ECB task force to assist the advancement of the green agenda across the euro area. The ECB is also a member of the Network for Greening the Financial System (NGFS). Within the network, which includes other central banks and financial regulators from five continents, the ECB supports the transition towards a low-carbon economy.

These actions are important, increasing awareness among market participants and fostering the development of ethical financial instruments. Nonetheless, they limit the ECB's role to that of a "commentator" on the market situation which forecasts, analyses, evaluates and supervises, but does not actively create the market. Meanwhile, the unprecedented demand for bonds that the ECB generates through the APP determines price formation on the secondary market and gives the bank real power to shape the market.

This essay examines the power of the ECB to steer demand for bonds towards ethical debt instruments in order to make a real contribution to the development of an ethical debt market. First, the legal and economic context in which the ECB currently operates will be discussed, to establish the legal basis and the economic rationale for focusing its purchase programme on ethical bonds. Next, two scenarios will be considered for a targeted purchase of ECB's ethical bonds: under the current APP and under a separate, dedicated purchase programme. Finally, the current legal situation of the ethical bond market and the role of the EU in the ECB's ethical bond purchase action will be outlined.

Legal context of the ECB's purchase programmes

Primary law makes the European System of Central Banks (ESCB) responsible for conducting monetary policy. Article 127 of the Treaty on the Functioning of the European Union (TFEU) states "the primary objective of the European System of Central Banks ... shall be to maintain price stability". However, the article continues: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union". The goals listed in Article 3 of the Treaty on European

Union (TEU) include among others "balanced economic growth ..., [a] social market economy aiming at ... social progress and a high level of protection and improvement of the quality of the environment". It follows from the two treaties that while the main activities of the ECB are focused on maintaining price stability in the euro area, the bank also supports other Union policies, such as sustainable growth, social progress and improving the quality of the environment. Consequently, promoting the development of a market for ethical social and environmental bonds is not only a wise choice by the ECB but also its duty.

The powers granted to the ECB are considerable. Enjoying substantial autonomy, due to the relatively limited number of treaty provisions governing its operation, the ECB has been able to design a new, non-standard instrument to advance its monetary policy, the APP, which was not originally foreseen. The primary task of the ECB is to monitor price stability, as provided for by Article 127 TFEU. To meet this task, the ECB has various instruments, such as the system of minimum reserves or open market operations. Under open market operations, "the ECB ... may operate in the financial markets by buying and selling outright ..." At the same time, Article 123 (1) TFEU stipulates that "the purchase directly from [Member States] by the European Central Bank ... of debt instruments ... shall be prohibited". The combination of these provisions has allowed the ECB to create an instrument of "operations in the financial markets by buying" sovereign bonds "not directly from the Member States", i.e. on the secondary market, in order to achieve a better transmission of monetary policy, thus achieving price stability.

The framework of the programme is entirely determined by the ECB. The bank sets its volume through the rate of monthly purchases and the proportional distribution of purchases among countries, based on the so-called key for capital subscription. In addition, the ECB determines purchase limits in relation to the issuer and a specific security, and limitations on the execution of purchases. The ECB has resolved that, with regard to the PSPP, a certain minimum and unspecified period must elapse from the issuance of bonds until the possibility of their purchase by the ESCB, the so-called blackout period; this is to prevent the ECB from having any influence on price formation in the primary market. The ECB also only publishes data on total purchases at an aggregate level. This set of self-limiting measures by the bank is to guarantee the programme's compliance with Article 123 (1) TFEU.

Controversies around the ECB's purchase programmes

However, concerns about the lawfulness of the purchase programme, especially in its public part, have been regularly raised since its onset. The German Federal Constitutional Court requested the Court of Justice

of the European Union (CJEU) to investigate a possible breach by the ECB of its mandate and of the prohibition on financing the EU member states. On 11 December 2018, the CJEU confirmed the monetary nature of the PSPP and thus its legal validity. In justifying its judgement, the CJEU found that because the injection of liquidity provided by the PSPP to the private sector facilitates credit provision to the euro area economy, supporting in this way aggregate consumption of firms and households, the higher expenditure thereby stimulates price growth and ultimately contributes to achieving the ECB's inflation target. It follows that the purpose of establishing the PSPP is price stability and therefore it falls under the ECB's mandate.

The opinion of the CJEU is extremely important for considering the role that the ECB could potentially play in advancing an ethical debt market. The CJEU's decision means that the basis for the validity of the purchase programme is its goal. The programme is legally valid because it seeks to improve the transmission of the ECB's monetary policy and, consequently, achieve price stability. It follows that the pursuit of any other goals, such as support granted to member states or, in the context of this discussion, facilitating the development of an ethical debt market, cannot invalidate the programme.

At the same time, the CJEU acknowledged the lawfulness of the programme only "as is,": specifically, in the form in which it was presented to the court, with all the underlying guarantees mentioned above. This point was stressed by the Advocate-General of the CJEU, Melchior Wathelet in his opinion on the judgement: "The validity of a programme such as the PSPP is therefore dependent on the guarantees surrounding it". A different programme structure, or any subsequent modifications to its form, such as linking purchases with the ethical nature of securities, could therefore potentially result in a negative assessment of its validity by the CJEU if the programme's ultimate goal was no longer monetary.

The above analysis demonstrates that the validity of the purchase programme rests on its monetary nature. However, beyond the programme's legal validity, a question also arises about the purpose of purchasing ethical debt instruments. Is the ECB able to have a real impact on the development of an ethical debt market through its ethical securities purchase programme?

The relevance of securities purchases to an ethical debt market

The ECB is already purchasing green bonds under both the public and the private components of the APP. The exact volume of purchases remains unknown, because the ECB does not disclose statistics on specific securities and only publishes aggregates for a given month, due to the as-yet modest size of the market. In the case of the public sector, green bonds still only account for

around 1 per cent of the euro area's entire sovereign bond market. The ECB's green bond portfolio is consequently small, and analyses show that covering these bonds through the purchase programme has already contributed to falling yields, increasing the issuance of such bonds by the non-financial sector. For example, the trajectory of green corporate bond yields before and after the launch of the CSPP programme on 10 March 2016 shows a clear narrowing of the spreads between green bonds and reference bonds. The demand driven by the ECB has enabled issuers to finance their green spending at a lower cost, thus providing a stimulus for a more active engagement in environmental projects.

Despite the fact that the ECB already purchases green bonds under the APP, the framework of the programme does not provide for any declarative environmental or social objective. The purchase of green bonds by the ECB is therefore carried out as a "side effect", because these bonds made it to the basket of securities that were available for purchase. In fact, one of the distinguishing features of the APP is its multilateral neutrality. In the case of the PSPP, it is primarily expressed through proportional purchases made among EU countries, corresponding to their share in the ECB's capital – the "key for capital subscription" mentioned above. In the case of private sector instruments, purchases of green bonds are aligned with the availability of securities across different business domains and ratings. Other attributes of the APP that testify to its neutrality include purchases along the entire yield curve, adjusting the size of its programmes proportionally to demand and to regular inflation-adjusted revisions in line with the inflation target. The wide range of criteria is intended to allow for flexibility regarding the available instruments. Yet it also means that the APP does not discriminate, either positively or negatively, on the basis of the ethical or non-ethical nature of traded securities.

Against this background, the question arises whether the ECB could "stitch" ethical bonds into its purchase programmes in such a way as to contribute to supporting the development of an ethical debt market. In other words, does the ECB have the capacity to make ethical debt a point of interest for securities purchase programmes? There are two options for combining the ECB's purchase policy with ethical bonds: either under the existing APP or under a new programme devoted exclusively to ethical debt instruments.

Purchase of ethical bonds under the APP

In order for ethical bonds to make their way into the APP and have a specific purchase percentage allocated, it would in the first place have to be technically feasible. As mentioned earlier, the PSPP is the largest of the APP's schemes. Despite

the positive trend of issuing ethical debt among European countries, the market for ethical sovereign bonds is still relatively small. One of the main assumptions of the APP (and one of the main reasons that the CJEU approved the programme) is to conduct purchases according to the capital key. Meanwhile, most euro area countries have not yet issued any ethical sovereign bonds. Due to both these factors, the even distribution of purchases of ethical debt instruments among EU member states is not possible.

Beyond these technical aspects, in order to link the APP with ethical debt the ECB would have to justify that their purchase specifically supported the programme's objective, compared to the purchase of "standard" bonds. This objective is "further enhancing the transmission of monetary policy, facilitating credit provision to the euro area economy, easing borrowing conditions of households and firms and contributing to returning inflation rates to levels closer to 2 per cent, consistent with the primary objective of the ECB to maintain price stability". The ECB thus justifies the implementation of the APP on the grounds that the purchase promises price stability through better monetary policy transmission. The question that then arises is whether the purchase of ethical bonds has a higher monetary policy transmission potential than the purchase of conventional securities and, therefore, deserves a special place in the APP.

Meanwhile, the ECB's rationale for implementing the APP is purely monetary. Referring to the PSPP, the ECB explains that "the sizable purchase volume ... will contribute to achieving the underlying monetary policy objective of inducing financial intermediaries to increase their provision of liquidity to the interbank market and credit to the euro area economy". The purchase of securities on the debt market is intended to increase liquidity in the financial sector, as this will further relax borrowing conditions for the real economy, meaning for businesses and households. This relaxation will in turn contribute to an increase in consumption and investment, and thus will translate into an increase in inflation. The direct objective of the APP is therefore to provide liquidity to banks which can then transmit it into the real economy through their lending activity, rather than funnel liquidity into any specific economic sector. Consequently, the ethical or unethical nature of bonds does not have a bearing on the operations of the APP.

Could the ECB overcome this problem by designing a separate debt purchase programme dedicated solely to ethical debt instruments?

Purchase of ethical bonds under a new programme

As noted, any ECB debt purchase programme must first and foremost serve monetary purposes, as confirmed by Article 127 TFEU. A new programme, under which the ECB would purchase only ethical

bonds, would therefore have to demonstrate that the provision of liquidity to specific sectors of the economy, related to sustainable, green or socially responsible growth, can significantly contribute to restoring or maintaining price stability.

In this context, climate change and social inequalities are not impervious to the formation of market prices for goods and services. Droughts affect the supply of agricultural crops and drive prices up. Floods damage infrastructure and private property and increase insurance coverage costs in hazard areas. Global warming causes fluctuations in energy prices, which are a constituent of the Harmonised Indices of Consumer Prices (HICP) used by the ECB. Overregulation leads to higher operating costs for enterprises and, consequently, higher manufacturing costs. These short-term volatilities, if not properly addressed, could have long-term effects on inflation growth, as Lagarde has cautioned.

Given the above, the purchase of ethical debt instruments aimed at preventing such environmental or social effects and thereby counteracting inflationary pressure, has a monetary dimension and thus falls within the scope of Article 127 TFEU. Consequently, the ECB has legal grounds to purchase ethical bonds, alongside conventional bonds under the APP, not only "incidentally" but also to cover them intentionally through some of its purchase schemes.

The ECB itself contends that unfavourable social outcomes or climate change may directly affect inflation. From this perspective, Article 127 TFEU provides that the ECB has not only the option but an obligation to take preventive action. For example, at the end of 2018 the markets expected the APP to come to a close, and hence awaited a general reduction in demand for bonds. The bond yields, including those on green bonds, began to increase and the issuance of new bonds became less attractive to the issuers, as they were forced to pay higher interest on the new instruments. Anchoring interest rates on ethical bonds at a lower level (had the ECB continued to purchase them) would have encouraged issuers to channel their cheaply raised capital into ethical investment projects. The development of an ethical debt market would thus have received significant support by focusing the purchases on ethical bonds under a separate programme, independent of the current general market conditions, but determined by the relevance of ethical areas of the economy for price formation.

Precedence of the ECB's special purchase programmes

In fact, it would not be a novelty for the ECB to establish a special purchase scheme of this type, launched with the specific aim of intervening to counteract undesirable developments in price formation. In response to the COVID-19 epidemic, the ECB devised a temporary Pandemic Emergency Purchase

Programme (PEPP) that structurally mirrored the APP. The goal of the PEPP was to counter serious threats to the monetary policy transmission mechanism caused by the epidemic. The ECB responded to a specific threat – the epidemic – which had implications for the transmission of monetary policy and, consequently, for price levels. Similarly, an ethical asset purchase scheme would seek to support specific, ethical changes in the economy, thereby improving the transmission of monetary policy and managing price formation.

Despite the special nature of the PEPP, its structure resembles that of the APP, with the validity of the public component confirmed by the CJEU judgement discussed above. In particular, the PEPP is managed by the capital key, meaning that it maintains the proportionality of purchases with respect to issuers, which is particularly relevant when purchasing sovereign bonds, given that the ECB is prohibited from directly financing EU member states under Article 123 (1) TFEU. If the ECB were to purchase ethical bonds (which still have relatively low liquidity, with some EU countries yet to issue them), it would not be able to do so while respecting the capital key. Therefore, it would be unclear whether a programme driven by the character of the bonds while remaining.selective as regards issuers could be consistent with the ECB's mandate, since it would fail to meet one of the basic criteria of the APP that secured the CJEU's approval for the PSPP.

In the past, however, the ECB has run purchase programmes that were not aligned with the capital key rule: for example, the Securities Markets Programme (SMP), launched in order to solve the problem of non-liquidity and dysfunction of the debt markets in Greece, Italy, Portugal, Ireland, and Spain; and Outright Monetary Transactions (OMT), where the ECB can purchase secondary market debt securities of countries where the transmission of monetary policy is disrupted. OMT remains one of the ECB's monetary instruments, although it has never been used to date. Both programmes envisaged an issuer-selective purchase of sovereign bonds determined by disturbances in the transmission of monetary policy and bond price instability in some European countries. The CJEU, which had the opportunity to address the OMT in its 2015 decision on Gauweiler and others versus the German Bundestag, stated that the specific assumptions of the programme made it monetary, and thus the programme could be carried out, even if it permitted the purchase of sovereign bonds from only some European countries.

The CJEU's approval of the ECB's existing practice as regards the OMT and the PSPP suggests what elbowroom the ECB would need to have in order to establish a new purchase scheme dedicated to ethical bonds. Apparently, as long as the programme goal is monetary, with the purchase aimed

at maintaining price stability, the public part of the programme does not have to be aligned with the capital key. The monetary goal of purchasing ethical bonds would justify its implementation, despite the limited pool of issuers because of the currently small size of the ethical bond market. A programme designed in this way would not violate the principle of neutrality because, as in the case of the SMP and OMT, such purchases would not aim to support specific private issuers or member states financially but would be motivated by monetary considerations in purchasing ethical bonds, regardless of the issuer. As long as the purchase was made proportionally in relation to ethical issuers, the principle of neutrality would be respected.

Formal definition of the ethical debt

Although the ECB is already actively involved in combating climate change, its action still lacks an explicit social agenda. This absence deserves attention because of the impact of social inequalities on financial stability. As shown in the above analysis of the legal context of the ECB's operations, the bank has a legal basis for a new purchase programme that is separate from the APP. Such a programme would focus solely on ethical bonds in order to generate demand to support sustainable development investment and curtail the undesirable impact of climatic and social phenomena on price formation.

At the same time, under such a new scheme, the bonds subject to purchase would have to demonstrate unambiguous ethical attributes. Despite the growing popularity of ethical debt instruments in recent years, they have not yet been legally defined, either in domestic or supranational laws. The reasons for this lie in the fact that ethical securities do not formally represent a new legal concept of debt securities, whether in relation to issuer, security, or method of admission to trade. Instead, they fit into the legal definitions of the already existing debt instruments, as sovereign bonds, municipal bonds, corporate bonds, covered bonds, and so on.

To address this problem of legal definition, the International Capital Market Association (ICMA) has proposed the adoption of the following criteria to determine the social or green character of a bond: use of proceeds, meaning whether the acquired funds, in whole or in part, produce social or environmental benefits, such as promotion of universal access to food, drinking water or transport, development of green buildings, investment in renewable energy; project evaluation and selection process, i.e. whether the issuer clearly communicates project selection or rejection criteria to investors; whether the issuer clearly communicates project selection or rejection criteria to investors; management of proceeds, meaning whether the issuer properly supervises the use of funds obtained

from ethical bonds for the declared purposes; and reporting, meaning whether the issuer provides investors with information on the use of funds in a transparent and regular manner.

At the EU level, when SURE (Support to Mitigate Unemployment Risks in an Emergency) was established following the COVID-19 outbreak, it was assumed that the social character of the bonds reflected the ICMA's guidelines. However, the ICMA does not have sole authority in this area. For example, when issuing a green bond in 2008, the World Bank asked the independent Norwegian think-tank Center for International Climate and Environmental Research (CICERO) to provide a second, independent opinion on whether the bond had an ethical nature. Meanwhile, different rating agencies are involved in the evaluation of ESG criteria, yet these ratings are inherently subjective and often misaligned with other ratings, due to different methodologies.

Issuers and investors must therefore cope with guidelines for ethical bonds which are not standardised and are often imprecise. Opinions vary over the correct threshold for determining whether a bond qualifies as "green". Does it require 100 per cent, 50 per cent or only 20 per cent of raised proceeds to be allocated to environmental initiatives? Similar differences exist over how to measure social benefits. The absence of legal provisions formally regulating the green or social nature of debt instruments means that the ethical label is not sufficiently defined and, thus, not credible, especially if the issuer is a less prominent entity than an EU member state or a supranational organisation. Insufficient clarity in this regard affects both investors' assessment of bond risk and potential yield and the investment decision itself. The sheer range of recommendations, guidelines and market practices is not conducive to market transparency.

The standardisation of the ethical bond market is thus a prerequisite for its further development and an obligation for the EU regulator. Article 3 TEU states that sustainable growth, full employment, social progress and improvement of the quality of the environment fall within the EU's remit. Through the promotion of social and environmental goals, the EU assumes an obligation to support the development of an ethical debt market.

Defining green securities

The EU is currently working on standardising the definition of green bonds. The aim of the regulation, which is scheduled for the end of 2022, will be twofold: to reduce market fragmentation, attributable to existing market and national practices; and to combat greenwashing, meaning products that do not meet basic environmental standards but merely "pretend" to be green. This coherent EU regulation for green bonds will increase market transparency and foster investors' trust, thus significantly contributing

to the further development of the market.

There is also the question of how best to regulate the social bond market. So far, the EU has introduced an obligation of non-financial reporting by some large entities "in order to enhance the consistency and comparability of non-financial information ... relating to ... social and employee-related matters, respect for human rights, anti-corruption and bribery matters". However, there is no single definition of ESG which, as with the green bond market, would provide issuers and investors with a clearer picture of the criteria and thereby stimulate further market development. The EU should therefore start work on the legal framework of the social debt market, following the green bond classification model.

The introduction by the ECB of a new ethical bond purchase programme would have to be contingent upon the development of an EU-wide classification system for green and social bonds that would reassure investors (in this case the ECB) that the purchased instruments contributed to the promotion of ethical aspects of the economy. Once the EU has defined the legal framework of ethical debt instruments, the ECB will hold the full mandate to launch a new bond purchase scheme focused on ethical bonds. •

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Part IV

Ethical Issues in Banking and Regulation

The case for a more sustainable banking regulation framework

Ethics & Trust in Finance
Global edition 2022-2023

Second Prize *ex-aequo*

Florian Barras
Switzerland
Graduate Assistant,
University of Lausanne,*
Lausanne (Switzerland)

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

Recent complaints by NGOs, academics and regulators about the lack of serious action taken against greenwashing highlights a major problem in the banking industry. Alarmingly, the Bank for International Settlements has compared climate risks to black swan events, calling them *green swan events* because the question is not if, but when these events will occur. In this paper, I argue that this mismatch between what is being done and what is needed stems from a vision of sustainability that fails to address current climate and social challenges. Indeed, there are two main visions of sustainability, *weak sustainability* and *strong sustainability*. To date, market-based initiatives in international banking have focused mainly on the former, through corporate social responsibility initiatives or voluntary participation in programs such as the United Nations Environment Programme Finance Initiative. The apparent lack of ambition of these initiatives to enforce concrete climate and social imperatives which could negatively impact profitability in the short to medium term shows the limitations of the current paradigm of sustainability in banking. Banking regulators who focus on system-wide stability rather than immediate profitability appear to be the best emergency responders in the current circumstances - even though some have historically rejected such a role. For example, FINMA, the Swiss financial regulator, states that its role is to protect against greenwashing and climate risks, but not to actively promote climate-friendly banking activities, which is a somewhat confusing stance. There is a growing

need for ethical renewal to avoid a catastrophic shift in future climate conditions, and regulators could be the agents of such change. This paper aims to offer a new theoretical and operational framework to encourage regulators to support the banking sector to focus on the concept of strong sustainability.

Weak vs strong sustainability

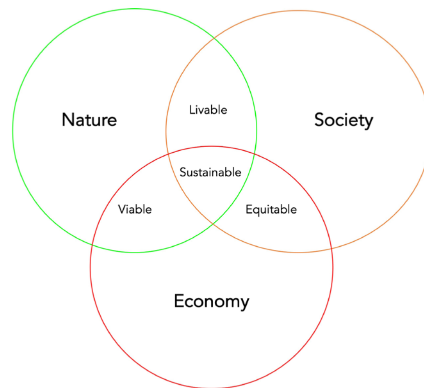
The concept of sustainability in mainstream policy discussions was created as a successor to the term *ecodevelopment* and was further refined in the UN report Our Common Future (1987), commonly known as the Brundtland report. The main idea was to meet the needs of the current generation without compromising the needs of future generations. However, the concept of sustainability quickly became so loose that its definition could be adapted to all sorts of practices, sometimes even contradicting each other. As a result, the term has evolved into *sustainable development*, which emphasizes economic growth as a necessary condition for nature and society . In this paper, I argue that sustainable development creates the conditions for the lack of climate and social ambition in banking.

"Weak" sustainability: why we shouldn't take it lightly

Weak sustainability is the more derogatory term used by proponents of strong sustainability to describe sustainable development (sustainable development and weak sustainability will be used interchangeably in this paper).

As shown in Figure 1, sustainable development offers a model of three equal dimensions within human societies: the environment, society and the economy.

Figure 1: Representation of sustainable development, adapted from the Brundtland report (1987)



In sustainable development, there are three distinct spheres: nature, society and the economy. The three spheres are interconnected but not necessarily interdependent. A society that takes into account the economic and societal spheres but not the natural sphere is equitable. It is viable when only the economic and natural spheres are taken into account, and livable when it encompasses nature and society but not the economy. When all three spheres are taken into account, this creates a sustainable society.

Equal spheres

The key word here is *equal*, meaning that economic needs are as important as environmental and social needs. In Figure 1, the three circles have the same dimensions, and parts of them are independent of each other. Furthermore, as the emphasis of sustainable development is on future generations, in order for the concept to be understood and applied, one has to assess future needs. However, it is impossible to predict with certainty what future societies will look like, which in turn creates a concept of sustainability that allows for broad interpretations based on the projection of future realities. This is one of the reasons why the concept has been reinterpreted as sustainable development by the private sector and, in this paper's case, by banks, which have been criticized for using it to promote business-as-usual activities. For example, from a sustainable development perspective, a society may decide to extract minerals from a mine, which is equivalent to extracting natural assets to create man-made capital that can be passed on to future generations – for example, through technological knowledge. Indeed, such a society might consider man-made capital as equally important for future generations' needs as natural capital, meaning that from a sustainable development perspective, the use of non-renewable resources is considered sustainable if it creates other types of value that can be shared between generations. Therefore, since the environment is a dimension parallel to the other two, the benefits need to be demonstrated in order to be taken into account, especially from a return-on-investment perspective on which mainstream banking is based. Indeed, if profitability is the way to judge whether behaviors are normatively good or bad, then preserving the environment must provide banks with an economic return. This refers to the idea that banking actors create a narrative about the environment as being either an opportunity or as something that has no negative impact on profits. Since incorporating the environment into the business model is a *free* choice, such a choice must be financially attractive. In mainstream economics, this follows from the utilitarian notion of money as a proxy for well-being. This growth and economy-centered view is a key building block for the concept of sustainable development.

Why we should see sustainability as a cost

However, investing in integrating social and environmental issues such as foregone economic opportunities into business does not usually translate into direct profitable returns, especially for investors themselves. For example, in terms of economic returns, abandoning or divesting from *carbon bomb* projects appears to be a very expensive proposition for companies and

banks, and any compensation from marketing gains or better management of long-term risks appears insufficient compared to the loss of economic opportunities. This means that the lack of action on climate and social justice appears to be mainly due to a mismatch between the type of institutions that produce the most impacts and the type of institutions that are better placed to deal with these issues. Indeed, the fact that environmental and social issues are system-wide problems with no direct individual benefits means that individual organizations such as corporate banks have no vested interest in being proactive in terms of sustainability. As most crises show, the best strategy for any individual bank is to hold on to its investment strategy and assets as long as possible before a crash, hoping to transfer the risks to someone else before they materialize. However, in the case of climate and social justice, there can be no winner if the risks materialize. Therefore, the narrative of contextualising the environment as a good investment gives false hope, as shown by the continued absolute rise in CO_2 emissions across the financial sector.

Integrating sustainability into the mission of financial regulators

In order to avoid this type of behavior and the environmental and social consequences that result from it, regulators appear to be the best first responders in the climate emergency scenario that today's society is facing. Indeed, the limits of weak sustainability in banking and its narrow utilitarian framework show that regulators are perhaps best placed to prevent crises through a paradigm shift, as they do not have individual economic goals. Their objectives are sector-wide, and their macroeconomic vision is therefore better suited to addressing climate and societal issues. However, it has become a trend to adhere to the narrative that tackling climate change is "sexy", and regulators are falling for it as well. The former governor of the Bank of England, Mark Carney, said in a recent interview that: "[t]he dialogue has shifted from viewing climate change as a risk, to seeing the opportunity" (United Nations, 2023, second paragraph). This interpretation of sustainability means that with banking being central to any capitalist economy and regulators being their best bet to act quickly, maintaining the current narrative could hinder the ability of human societies to meet the 2015 Paris Agreement target of limiting global warming in the present century to 1.5°C. Hence, there is an urgent need for regulators to recognize their role as system-wide entities in the context of climate change and increasing social injustice, as well as their current shortcomings due to their ethics framework. To do this, however, there must be an alternative. The concept of strong sustainability offers a clear, practical

way to create a new ethical vision for regulators.

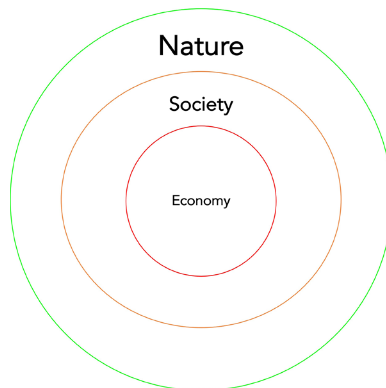
"Strong" sustainability and how to prevent greenwashing

The main alternative to weak sustainability is the idea of strong sustainability. Strong sustainability is an ethical stance that recognizes that the economy is a product of human societies, which in turn are a product of nature. While weak sustainability is non-hierarchical, meaning that natural and human capital are considered equal, strong sustainability prioritizes natural capital over human capital. Moreover, within human capital, social capital is more important than economic capital. This means that there is a hierarchy between the three dimensions of nature, society and economy. From this standpoint, modern societies cannot extract finite resources or influence the stability of the natural world, recognizing that it inevitably affects the living conditions of all species, including humans.

Overall, this means that the theory of strong sustainability remains bounded between nature's ceiling and society's foundation, as proposed by economist Kate Raworth in her 2017 book Doughnut Economics.

In strong sustainability, as shown in Figure 2, the economy is embedded in social and environmental conditions. The figure above represents the initial concept of strong sustainability,

Figure 2: Representation of strong sustainability, based on Giddings 2002



The framework of strong sustainability embeds the economy within society, which in turn is embedded in nature. This means that the economy can only function through the conditions created by the societal and environmental context, demonstrating the interconnectedness of the three spheres and their hierarchical dependence. Indeed, in this representation, nature does not need society or the economy to function well. This framework also assumes that society does not need the economy to function well, perhaps by taking into account different models of society that are not built on a free-market social structure. However, in this model, the economy needs society and nature to properly function.

based on the embeddedness of the economy in society and nature. This system analysis highlights how nature, society and the economy interact and how interconnected they are. So far, neither banks nor regulators have embraced this vision of sustainability since it has a different normative ethical standpoint than their own one and is not as loosely defined as sustainable development. However, I argue that sustainable development bets on a high-risk future in which economic capital can replace natural or social capital through technological innovation, whereas strong sustainability prioritizes evidence that demonstrates the preservation of natural and social capital. This latter vision is significantly more conservative in the current context. I would argue that there is an urgent need to shift the sustainable vision of banking from weak sustainability to strong sustainability in order to ensure that the Paris Agreement's 1.5°C global warming target is met.

Two steps to implement strong sustainability in banking

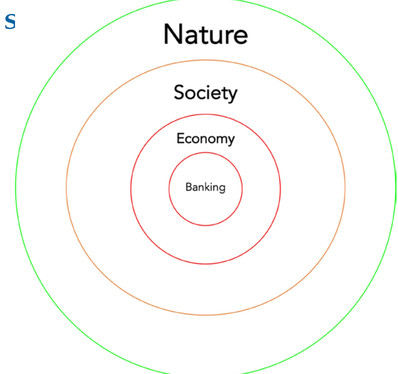
In order to implement strong sustainability in banking, I have identified two steps: (1) there is a need to embed banking into the three dimensions of strong sustainability - namely nature, society and the economy; and (2) we need an ethical perspective that allows for different values to be considered in the framework. This could create a two-step model that would allow the recognition of the values that inspire practices and help to embed the banking system into the three spheres of strong sustainability.

Embedded spheres

The first step in implementing strong sustainability would be to put the banking sector back at the center of the three realms, showing their mutual dependence. To do this, I have modified the original strong sustainability representation, and placed banking at the center of the whole system (see Figure 3).

By placing banking at the center of the circles, Figure 3 shows that the sector needs to recognize its dependence on the natural world, society and the economy, as discussed above.

Figure 3: Banking embedded in the three s



This figure represents banking as an activity embedded in – and thus dependent on – the economic, societal and environmental spheres.

Overall, a banking system that uses the strong sustainability framework needs to recognize its embeddedness at the center of these three dimensions, all of which need to function well for the banking dimension to function well.

Virtue ethics

To recognize this embeddedness, there is a need for a different or broadened ethical framework than the current narrow utilitarian one. In recent years, many scholars in the field of business ethics have begun to advocate the need to move beyond utilitarianism in order to integrate new core values in finance.

In the case of weak and strong sustainability, the ethical framework of virtue ethics could provide key insights to help differentiate the type of sustainability on which individual banks build their processes. There are central key values in both sustainable concepts that are different, and virtue ethics allows these values to be understood and put into the context of banks' processes. Regulators could thus use values and their associated processes as a key means of assessing sustainability.

Virtue ethics assesses the conditions for a good life through the analysis of disposition and character. These two aspects form the basis for developing virtues (or vices), which in turn influence how one acts. However, having certain dispositions or character traits does not mean that they are permanently activated. Indeed, one can have a disposition or a character trait without it leading to any specific behavior. For example, one might have the disposition to care for nature, but without the context of experiencing nature; someone working in a bank office disconnected from the natural world might not activate this disposition. Consequently, a bank that does not foster such a disposition may lack the intrinsic drive to act in accordance with nature's needs. Virtue ethics helps to highlight the role of organizations in creating the conditions for the activation of virtuous dispositions or character traits by their stakeholders. However, not all dispositions are beneficial to society. Indeed, some dispositions might be destructive, such as the dispositions for greed, malevolence, hate, and so on. In this case, organizations also bear the responsibility for fostering these dispositions, or not.

Values as a way of fostering virtuous dispositions

An important way of fostering dispositions is through the creation and communication of values. In this case, values can be defined as a lighthouse for behaviors, while virtues (or vices) are the enactment of values. Therefore, in order for the banking sector to foster virtuous behavior, it has to possess strong values. According to the argument of this paper, the activities of a banking sector that considers strong sustainability through the lens of virtue ethics must align its values

with the needs of the economic, social and environmental spheres, enabling banking to create virtuous behaviors.

From a utilitarian perspective, virtues and vices are not so relevant if they can both lead to the same outcome at a given point in time. An organization that fosters vices in order to emit less CO_2e is equivalent to an organization that fosters virtues, if the CO_2e emissions at the end of the year are the same. This relates to the fact that sustainability in banking is mainly assessed in terms of cumulative CO_2e emissions, rather than in terms of multiple types of outcomes or the processes that lead to these outcomes. In this case, virtue ethics could assess CO_2e emissions as a process that starts with the creation of value and ends with the long-term consequences. Virtue ethics is therefore interesting as a way of understanding and differentiating between the two types of sustainability. This does not eliminate the need for quantitative impact assessments, such as measuring CO_2e, but complements it. Moreover, to avoid the fate of weak sustainability, strong sustainability frameworks should be interpreted as a set of deontological principles to create a foundation on which to build key values. Such an interpretation of strong sustainability should minimize the possibility of conflicting definitions, based on the four embedded circles. This could be done with principles such as prioritizing the preservation of environmental conditions that have existed since the end of the Ice Age, aiming to redistribute economic benefits equitably, and limiting inequalities between and within countries to a certain optimal level of well-being, after taking environmental considerations into account.

Virtue ethics and the values of weak and strong sustainability

Steg, Perlaviciute, Van Der Werff, and Lurvink (2014) developed a broad set of human values which puts into perspective the values found in weak and strong sustainability. They distinguish four types of values: biospheric, altruistic, hedonic and egoistic. Typically, weak sustainability appears to be better assessed by hedonic and egoistic values. These values relate to pleasure, self-indulgence, social power, authority, wealth and ambition. Biospheric and altruistic values can also be found in weak sustainability, such as avoiding pollution or being sensitive to the aesthetics of nature. (Values from neoclassical economics could be added to this list, such as self-regulation, individuality, negative freedom, competition, rationality, infinity, transhumanism, technological innovation, conservatism, economic profitability, charity and control.) However, not all values from this framework fit into weak sustainability. For example, biosphere values,

including the protection of natural resources, cannot be associated with weak sustainability. In fact, the interchangeability of natural and economic capital, which is a key component of weak sustainability, directly contradicts this value, as protecting natural resources would impair a society's ability to extract economic capital from all non-renewable resources and limit those that are renewable. Similarly, the value of unity with nature does not appear as a value associated with weak sustainability, as the three spheres intersect but are not embedded in each other.

However, when considering values for strong sustainability, biospheric and altruistic values appear to be the most appropriate. Values such as protection of natural resources, preservation of nature, harmony with other species and oneness with nature all correlate with the idea of the environment as the foundation for sustaining life and human societies. Equality, social justice, peace and cooperation also relate well to strong sustainability, which embeds the social cycle in nature and surrounds the economic cycle. (Other values of strong sustainability might include recognition of finiteness, social innovation, tradition and traditional knowledge, simplicity and moderation, and positive and relational freedom.)

Some hedonic and egoistic values such as wealth do not seem to correlate with strong sustainability. Indeed, money is a product of the economy which depends on social and environmental conditions. Thus, in any strong sustainability setting, wealth values can only be understood as a subproduct of all other environmental and social values (and in such a case is probably not narrowly linked to financial wealth).

Why should regulators and banks assess values for sustainability?

The subprime crisis was an example of banks acting without taking into account values beyond financial returns. The failure to consider the economic cycle created the conditions for a global economic crisis. The processes that led to the crisis benefited a small percentage of individuals over a long period of time, until it turned into a situation that dramatically affected the entire banking sector. In Switzerland, one of the most exposed banks to subprime lending, UBS, lost close to $40 bn in the crisis and nearly went bankrupt. This demonstrated the consequences of acting on the basis of individual profit, on a vision that is disconnected from the needs of the economic system. Economic stability is a key component of banks' performance, and that is why banks are rightly embedded in and dependent on the economy.

Moreover, the crisis also highlighted the dependence of banking on the social sphere.

Contexts of political instability, wars or pandemics are examples of social issues that can affect the economic performance of banks. More nuanced issues of fairness such as social inequality also appear to be correlated with bank stability. For example, the European Central Bank (ECB) has recognized that *inefficient capital reallocation* is associated with more non-performing loans in the banking sector. In addition, the cultural context has an impact on banking. Indeed, for banks to act virtuously, they must have the structural conditions to do so. Societal conditions are key factors in determining values through culture. This shows how many different dimensions there are in the social environment that banks need to take into account in order for the sector to continue to thrive in a sustainable way.

Regarding the last and most important environmental sphere, it is also linked to banking sector conditions, as an increase in climate-related events due to climate change also increases the number of non-performing loans. Extreme weather events will not be the only types of issues arising from human impacts on nature. There will also be impacts on food systems, infrastructure, human health and many other dimensions. Indeed, the environment influences everything, which is why it is the largest and most important of the three sphere. Any disruption in this dimension is thus particularly worrying. In this framework, banking appears at the center of all the consequences that arise from disrupting the environmental, social and economic spheres.

Virtue ethics and its role in identifying the four spheres

In this context, virtue ethics helps identify these many types of dynamics which impact the financial system and offers a rationale for banks and regulators to take these into account in their products, processes, and culture. Indeed, the importance of virtue ethics lies in the fact that two similar processes can produce very different outcomes by adopting different values, such as acting from the perspective of weak rather than strong sustainability. Virtue ethics could therefore help to distinguish and understand these differences, especially when integrating the longer term perspective. By assessing values, it is possible to understand whether a culture, process or product is rooted in strong or weak sustainability. This will become even more important as experimentation is a fundamental requirement for trying out new models of sustainable banking. With virtue ethics and strong sustainability, regulators may be able to assess whether a new model is worth monitoring or regulating. So far, this framework is limited to highlighting certain key values, but in the future, regulators and academics should aim to create more knowledge in banking about different types of values related to

strong sustainability, their resulting processes and their outcomes. Specifically, this is most important in terms of social inequality and environmental preservation, where knowledge is currently most lacking. More quantitative outcomes can also help promote understanding of the link between key values and their impact when implemented in banking.

At present, one type of banking player - values-based banks - already seems to be leading the way in this area, and their insights and experiences could be useful.

Values-based banks as an example of implementing strong sustainability

There exists an alternative vision and implementation to weak sustainability in finance that could be considered close to strong sustainability. This vision comes from a group of financial institutions that have come together as the Global Alliance for Banking on Values (GABV) and call themselves *values-based*. Studies show that they appear to have a much lower environmental impact and are better at addressing social inequalities, although they are constrained in this respect by financial regulation. They offer most of the usual banking services, but they limit or align their services to the boundaries of the three spheres in order to create so-called positive change. For example, most values-based banks have a strict list of investment criteria that limits the types of companies in their investment and loan portfolios. While most conventional banks also appear to have some sort of ethical criteria, those of values-based banks are more aligned with strong sustainability values. Indeed, their criteria appear to be stricter and more normative in the ethical meaning of distinguishing right from wrong, taking into account ethical dilemmas such as consideration of animal welfare, controversial activities such as hardcore pornography, arms manufacturing or tobacco, or controversial energy sources such as nuclear energy. This is an example of a similar process with different outcomes because it builds on a different set of values.

The subtle - and not so subtle - differences between ethical banks

But processes are not always similar. For example, most values-based banks operate with some variation of horizontal governance, such as the Alternative Bank Switzerland - a member of the GABV – which implements sociocratic governance and does not currently have a CEO, being led by a board of four people.

Other processes specific to values-based banks are limited profitability, transparency regarding their corporate lending (often, who and how much ethical banks lend to companies and organizations is readily available on their website), limited ownership of the bank

(either through a cooperative legal status or by limiting the number of shares per person), and targeting the financing of the *real economy* (as opposed to the *financial economy*) through sustainable projects such as community housing, agriculture, or sustainability associations. Although not all of them are directly related to sustainability and the environment, these values-based banks practices show that the values that stem from strong sustainability produce long-term outcomes that contribute to mitigating negative environmental and social impacts. These different practices show how strong sustainability values create the conditions for many financial innovations from which the entire financial sector can benefit. This even applies to specific products, such as GLS Bank – another example of a GABV bank from Germany – which offers loans to individual projects that decide to come together and share financial responsibility, creating a potentially safer form of credit.

Ethical banking framework in conventional banks: it's not just about the processes

Currently, in line with what the proposed ethical framework demonstrates, many mainstream organizations have tried but failed to implement social innovation practices commonly found in values-based banks. Problematically, this can create tensions between regulators and new ethical banking models. In one such experiment, Deutsche Bank tried to implement a dual-CEO system from 2012 to 2016. This ended with the resignation of the co-CEOs and a return to the old leadership system. Control and competition values appeared as motivators to implement the social innovation of the dual-CEO system, which did not help to develop a collaborative relationship between the CEOs. This could be an example of an innovative process with values that were not aligned with strong sustainability, resulting in failure. Virtue ethics and strong sustainability highlight the need to analyze practises in terms of values, which in the case of a dual CEO system in values-based banks could be based on collaboration and democracy. In order for regulators to assess whether a situation will lead to good or bad long-term outcomes regarding banking stability (and therefore, good or bad long-term outcomes in the economic, social and environmental spheres), regulators require the tools to take into account values that are not considered in the mainstream utilitarian framework. The proposed framework, which blends strong sustainability with virtue ethics, allows for such an evaluation of practices and can help regulators to better assess banks' approaches to sustainability.

Concluding remarks

In summary, the two-step model proposed in this paper could help regulators recognize

the embeddedness of banking in the natural, social and economic spheres. Together, virtue ethics and strong sustainability can be used as tools to assess the sustainability of banking models and practices. Regulators could create and periodically update a set of values aligned to strong sustainability and qualitatively analyze the resulting practices of banks through this lens. A joint private and academic collaboration could further support this process of developing new ways to integrate ethical change in the banking sector in order to create strong sustainability. Strengthening sustainability frameworks may limit financial gains, but the arguments put forward in this paper argue for the integration of a new ethical framework in banking to protect the environment, and therefore the banking system, in the long term. Moreover, it could limit attempts at greenwashing, either by having the necessary tools to prevent it or by encouraging the banking system to integrate values authentically to build a vision of sustainability.

In a recent shift, France, through its economic development agency, has recognized the concept of strong sustainability as key to an authentic vision of sustainability. Moreover, there seems to be a growing interest in the banking sector, as the Deputy Governor of the Banque de France, Sylvie Goulard, used terminology from the ethical vision of strong sustainability. Strong sustainability therefore appears to be a promising concept that could go beyond the academic literature as a way to bring banking activities closer to the needs of nature, to a fairer society and, in turn, to a more stable banking sector.•

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Service to Others in Banking and Financial Services : Call to Action

Mohamed Ahmed Shallo
Kenya
Customer Experience Transformation Manager, SWIFT, La Hulpe (Belgium)*

Noah Sesi Nzuki
Kenya
Sustainability Manager, Artificial Intelligence and Analytics, Cognizant, Teaneck, New Jersey (United States)*

* The views expressed herein are those of the authors and do not necessarily reflect those of the Organization they are affiliated with or of the Jury.

Ethics & Trust in Finance
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Finalist

Banking and Financial Services: from Convenience to Ethics and Sustainability

Imagine travelling abroad for holidays. Then you walk into a local restaurant at a remote village, enjoy a local meal with heart-warming locals and pay the bill conveniently via a contactless transaction. At same time, you execute an instant international money transfer to buy a holiday gift for your family. Not only are you satisfied to have paid for a meal conveniently while abroad, but also because of the instant digital money transfer capability readily available at your fingertips. Convenient, fast, and secure: the buzz words of today's banking and financial services industry.

However, imagine again that, as a customer, your satisfaction with banking and financial services is not only limited to financial institutions meeting your instant payment convenience needs but also extends to a higher purpose, whereby your transaction contributes indirectly towards positive impact on society and the environment. This would represent a shift in customer satisfaction needs from pure realm of materialism to that of service to others and a sustainable future. Would this not lead to a more sustainable world as well as a more sustainable banking and financial services industry?

In fact, existing research demonstrates that because of service to others, life satisfaction and physical health improve and levels of trust and norms of reciprocity in a community increase (Post, 2005). This paper explores how by integrating sustainability into the banking and financial services

industry through service to others, trust and norms of community can be strengthened globally. It is a rallying call for the banking and financial services industry to integrate social, environmental, and ethical considerations into their business models and financial products.

On the one hand, the paper draws on historical accounts of business ethics and its application in Islamic banking, as exemplary models of sustainability principles, and on the other hand, it refers to the UN Sustainable Development Goals together with regulation for adoption. The paper examines how the financial payments industry can contribute to a better and more sustainable future for all. It proposes at industry level, a need for a set of commonly agreed ethical, environmental and socio- economic sustainability principles to serve as an overarching framework for the financial industry to achieve the highest possible standards of ethics and trust for a sustainable future.

It begins by providing background analysis and articulating the problem statement: why integrate sustainability principles in the banking and financial services industry? Secondly, it explores how sustainability principles that have industry-wide acceptance and are embedded accordingly could drive ethics and trust in finance, while ensuring innovation and measurable success outcomes, and still yield profitable business growth opportunities. Thirdly, it discusses the need for global facilitation and partnership on sustainability in the financial sector. Fourthly, it reflects on regulation, linking compliance monitoring and thought leadership to catapult the financial industry with regards to ethics and trust for a sustainable future. It concludes with a call to action to all stakeholders in the financial sector to take up the challenge as change agents; to create a better sustainable world in serving others, including our environment.

Rethinking Financial Business Models

Why integrate sustainability and development into existing business models?

When we think of embedding ethics in businesses, sources of inspiration can be drawn from far back in history. Here we take lessons from the 7th century, during the early stages of Islam, when principles were defined to reform a society that was mired in corruption, inequality, and self-interest. Islamic principles were defined to tackle malpractices of “extreme selfishness and ego” by creating a set of values of service to others (beyond the self) and caring for nature as living entities with a higher purpose to take care of the whole environment for sustainability.

Beneficial lessons can be derived from these spiritual principles and applied to finance, whereby the objectives are to bring about welfare and prevent harm, particularly in the preservation of life, intellect, property, and prosperity.

When reviewing early contributors to Islamic economics literature (Sairally, 2007), we see that the "socio-economic role" was superior to the principle of "profit maximization" and was applied to all the operators of the financial eco-system, from central banks to private commercial Islamic banks and non-bank financial institutions (NBFIs). This analysis is shared by economists such as Chapra (1985) and Siddiqi (1983). According to Chapra (1985), the Islamic financial set-up imposes an additional "socio-economic purpose" beyond the responsibilities assigned to them by conventional financial laws. These objectives are conventionally recognised and assigned to state banks and development agencies, and thus attributed to Islamic financial institutions (IFIs) as they are called upon to play a role in socio-economic development. Some of these Islamic principles further embed the concepts in the financial customer journeys within businesses and extend to clients' investment activity. They include the following objectives:

- Job creation and stimulation of sustainable entrepreneurship
- Alleviation of poverty
- Focus on promising sustainable economic sectors
- Fulfilment of broad socio-economic benefits
- Maintenance and dispensation of social justice
- Establishment of equity and fairness
- Promotion of regional distribution of investments.

An Islamic firm in general, and by extension an IFI, is regarded as distinctive in its behaviour (Sairally, 2007), since it cannot be guided by the single objective of profit maximisation (Mannan, 1992). It is argued that its behaviour "needs to be guided, among others, by the consideration of altruism – a concern for others to be shown as a principle of action" (Mannan, 1992). While conformity to the principles of shariah is believed to be essential in the behaviour of a firm, it is argued that every firm must also ask these questions: "What contribution is the output of the firm going to make?" and "who are the beneficiaries of the value-added component of the product of the firm?" In this respect, a concern for others, including not just the shareholders, but all the firm's stakeholders, is expected to be internalised within the firm's operations, including IFIs (Sairally, 2007). Such are examples of good principles in value creation in service for others over value destruction when reflecting on sustainability.

Until now, Islamic finance as a concept has been compared with parallel financial sustainability developments such as Socially Responsible Investing (SRI), and Socially Conscious Investing (SCI). Based on similar core values, such as individual responsibility, commitment to the social interest, promotion of human welfare, care

for the environment, concern for economic and social justice, and upholding the responsibility to shun harmful and unproductive activities, Islamic finance has been promoted as a socially responsible paradigm rooted in spiritual and religious tenets (Sairally, 2007). Embedding similar Islamic principles on a global scale, the UN's Sustainable Development Goals are a good start for an international conversation about how the world sets further principles for the financial eco-system collectively, just as there are public and private institutions in the global drive for sustainability.

It is commonly accepted that fulfilment of one's ethical and philanthropic responsibilities, while maintaining a profit seeking strategy, brings tangible benefits to a business (Sairally, 2007). Some of the recognised benefits are reported to be improved corporate reputation; better management of long-term risks by protecting the business from being involved in social and environmental scandals; increased employee satisfaction; stimulation of learning and innovation as companies identify new market opportunities; and improved market positioning and long-term profitability (Little, 2003).

Sustainability and Development Goals

Today many companies in the financial sector have pledged to help contribute to the UN's 17 Sustainable Development Goals (SDG) by 2030. This has been a phenomenal step towards promoting a global approach in tackling sustainability. It is also promising to see an evolution in thinking by the many financial institutions which have adopted these goals for their businesses. However, there is still a long way to go for scalable impacts and a need for more open conversations on how these goals can be embedded in business models beyond the 2030 sustainability targets set by the UN.

Covid-19 challenges and opportunities

The impact of the Covid-19 pandemic in meeting the SDG goals

Table 1: UN Sustainable Development Goals (SDGs)

has been mixed. It has set back progress towards achieving some of them, such as the first "no poverty" goal, given the job losses resulting from the pandemic. At the same time, there has been positive progress on other SDG goals: for example, the 13th goal on climate action, given how COVID-19 has reduced transport-related pollution through reduced mobility and acceleration of digital solutions as alternative connections. From an optimistic perspective, one can therefore approach the Covid-19 crisis as a positive opportunity to learn and improve.

In the financial sector, there has been a positive trend where banks and financial platform players have started to develop partnerships with organisations supporting education, microfinance, and financial inclusion in emerging countries. Financial companies have also reinforced their links with local communities in line with their strategy and business priorities. However, some institutions have not integrated this approach into their business priorities and taken the SDGs into account.

With year 2030 on the horizon, and more than 193 countries having signed up to the SDGs, the clock is ticking. This is an empowering opportunity for the banking and financial services sector to bolster development initiatives and analyse how they can be achieved collectively to strengthen sustainability. According to the Business and Sustainable Development Commission, reaching these goals by 2030 will generate 380 million jobs and unlock at least $12 trillion a year in economic development, much of it in developing countries.

We see a larger role and responsibility for the financial sector to make this realisation a success. To meet the ambitious SDG targets by 2030, the banking and financial services industry must play a critical role in providing both expertise and finance

A global sustainability approach

To facilitate an ambitious and coordinated worldwide industry approach, we see an opportunity for cooperative international organisations such as SWIFT, which is member owned by banks, to assume the following global roles;

- First as a global integrated transaction platform, SWIFT could integrate these sustainability principles into its value chain. Financial institutions using the SWIFT platform could contribute a share of the transaction and subscription fees to the SDG. This initiative could centralise distribution and reporting and help banks to create inclusivity in the transaction value chains and make an impact in each country of transaction origin.
- Second as a global sustainability facilitator of the financial sector, SWIFT could promote the global

conversation about sustainability and how banks and larger financial services players such as FinTechs and debit and credit card issuers can collectively make it a reality. This global process could in turn be strengthened by partnering with regulators and collaborating with the UN, just as different countries have been brought together to engage on sustainability issues at a national and international level.

Going beyond corporate social responsibility (CSR) departments

Today financial institutions typically have their UN sustainability and development goals driven by Corporate Social Responsibility (CSR) departments and sponsored by executives to instil these principles in the organisation. However, more is needed to embed these goals in the business model because there is often a disconnect between CSR and the organisation's business operations. Many organisations do not have clear-cut accounting mechanisms for how their revenues contributed to sustainability. If we are not able to measure and quantify how our business goods contribute to these larger goals, then the business model is disconnected from the sustainability targets. Furthermore, what happens after UN SDG 2030? Companies that meet all their sustainability goals as a checklist exercise, as opposed to embedding them into their business model, and risk not achieving sustainability in the long run as market conditions may change and erode their efforts. For example, the recent Covid-19 crisis has shown that market conditions can change rapidly, and institutions need to anticipate several scenarios for resiliency.

By contrast, companies that have not met all the SDG goals but have at least integrated them into their business models have created sustainability in execution rather than pure compliance. There are other companies which illustrate a combination of both scenarios. We therefore argue that now is the time to prepare for the future by bringing clarity to the grey areas.

Companies that see this moment as an opportunity to integrate sustainability into their business models will create transparency for their customers, many of whom also wish to contribute to making a better world. If executed correctly, this integration can therefore build customer loyalty by improving the overall customer experience.

A sustainability frontier for the financial eco-system

The financial sector must lead the drive to adapt and promote new economic and business models, against a background of formidable sustainability challenges, including the extremes of climate change, population growth and natural resource scarcity. There are several ways in which the financial eco-system can seize the opportunity to help promote these goals.

Examples include:

1. Financial institutions must promote sustainable practices in their business models and provide banking services and payment solutions that help alleviate social and economic challenges. Although not listed as an individual sustainability goal, financial inclusion is crucial to many of the SDGs, especially to alleviate poverty. By increasing efforts to reach the unbanked, the finance sector can help eliminate poverty, create jobs, improve healthcare, and promote gender equality. If not undertaken by financial institutions, similar efforts will be made by other players, such as telecom companies. In Kenya, for instance, the mobile money transfer service mpesa provides financial services to the un-banked. Our intention is not simply to highlight the potential of mobile banking, but also to consider how serving an underserved population can help achieve sustainability benefits.

2. Financial institutions must help their customers' businesses to move away from practices that undermine sustainability (SDG) and embed these lessons into their own banking operations. They could be proactive in creating sustainable portfolio solutions to support clients. Banks could enhance their Know Your Client (KYC) beyond anti- money laundering (AML) to include sustainability checks, to better understand the impact on sustainability from their clients' businesses invested from their services. This is not an easy task, as it may result in rejecting potential clients who may be acquired by competitors. However, we see the need for a collective effort by the financial sector which would create a more sustainable business environment in the long run.

3. Financial institutions, especially commercial lenders, international development banks and buy-side investment firms, have a unique role to play in successfully achieving these sustainability goals through their investment choices. Commercial banks are essential to finance the substantial investment needed to meet the UN's 2030 goals, which are estimated will cost between $5 trillion and $7 trillion per year. International development banks are crucial to opening viable opportunities for commercial banks. Finally, getting international investors on board is critical to funding these goals. Banks will need to persuade them to shift their focus away from short-term investments and embrace more long-term, development-based projects. For their part, investors will need to assess which financial institutions are measuring their progress towards sustainability goals. Therefore, there is an urgent imperative to have better integration of SDG into the business model of financial institutions.

4. Financial institutions should have SDG funding contribution embedded in their client transactions, purchase of goods and services, and ensure that each transaction, product, and service fee

include a contribution share that gets re-distributed to the source country in which the purchase was made. For digital transactions, this would mean the start or end-touchpoint location of the transaction. Perhaps in future, a chain of locations for transactions could be developed. But for simplicity, an initial touchpoint would be a good start, creating transparency, making the end client feel in charge, and reinforcing the notion that the financial sector is an enabler in promoting sustainability.

According to PwC, 90 per cent of citizens say it is important for businesses to sign up to the SDGs, while 71 per cent say they are already planning how they will respond to the goals. Meanwhile, 13 per cent of businesses have identified the tools they need to assess their impact against the SDGs, and 41 per cent say they will embed SDGs into their strategies and business operations within five years. This is the right moment for the financial sector to accelerate. By promoting the SDGs, financing specific projects, and reviewing the financial services they offer, banks can help their corporate customers match consumer expectations.

With 78 per cent of citizens now saying that they are more likely to buy the goods and services of companies that had signed up to the SDGs (increasing to 90 per cent in Latin America) this is good business for both banks and their customers. Furthermore, according to the same PwC research, citizens are keen to see businesses sign up to the SDGs, with Argentina (80 per cent) and Malaysia (70 per cent) being the most impatient in applying pressure.

Innovation and new market opportunities

Making the necessary adjustments to meet SDG goals will also bring innovation and new market opportunities as drivers of business growth. Banks that take the lead in this area will be the ones driving a more sustainable future. There is no time to waste, with just nine years remaining to fulfil the UN SDG 2030 goals, and the need to look beyond this deadline. This is a genuine opportunity for the banking and financial services industry to build trust and take a leading role towards a more sustainable future. We have seen that by shifting the way that the industry operates by integrating the concept of sustainability, citizens – in particular the clients of financial institutions - will have greater satisfaction in using the financial sector, thereby creating a collective effort to make a difference in each country where financial institutions trade.

Sustainable revenue models and customer journeys

Financial industry revenue models perform better by adding a sustainability principle to identify which revenue source to pursue, what value to offer, how to price the value, and who pays for the value. These are key components in a company's business model.

Exploring value further, financial institutions need a deeper understanding of their customers' intrinsic needs. In the context of sustainability principles, the new stakeholder is the "environment and society" and its relationship with customers.

When we talk about the customer experience and success, we usually mean understanding the customer's individual goals, needs and outcome objectives. The goals are typically what we try to solve to achieve their desires, while the outcome objectives are related to what we are trying to solve for them to succeed (Outcome Success Management). Lastly, the needs are often linked to perceived emotions and desires, as experiences. If customers' desires are to make the world a better place and they want to contribute to that cause, then being able to make a payment transaction in a country and knowing part of that payment transaction will contribute to the portfolio of sustainable goals will help turn these desires into reality. The customer thus becomes an active transaction player in improving the eco system, rather than remaining passive, while the environment also becomes an additional beneficiary stakeholder in the matrix. A practical way to apply this insight is for financial businesses to have sustainability elements embedded in their customer journeys and value maps.

A simple example of the "sustainability distribution revenue model" can be presented as follows:

- A bank or fintech has Product X for international payment transfer, and charges €10 for the wire transfer. If the bank applies a participatory percentage in its fee structure, then for every transaction a contribution of 2 per cent could be allocated to that country's sustainability investment. This would mean that for every transaction fee, the payment initiator would be contributing directly to the region.
- If the payment client initiator (let's say we call her Mrs. Hilma) uses, for example, ING bank, and if she is aware of this contribution, then she may eventually decide to make more transactions knowing that they are contributing to a better cause. This win-win for both parties does not remove other needs, where customers may be looking for more affordable fees. It is therefore incumbent on financial institutions to innovate to create value at an affordable rate while making the environment sustainable.
- If within six months Mrs. Hilma has made 200 transactions initiated in Country X, then this would amount to a total of €2,000 in fees in our hypothetical example, at €10 per transaction. Of this total, part of €40 would go directly to supporting Country X's sustainability goals. A similar contribution would apply if she

then travelled to Country Y or Z. Furthermore, if a global bank like ING had around 11 million customers worldwide, all making transactions at the same rate as Mrs Hilma, there would potentially be a contribution value extracted from around €440 mn for re-distribution to different countries.

- ING bank could also publish on its website all the sustainability investments conducted globally with its partners in different countries, using these contributions.

Distribution of benefits and transparency

Using the principles of Islamic finance described earlier, the goal of financial instruments would be to make society better irrespective of the domain. Investments should have a positive influence on the world. If we can make the UN SDG more accessible to end customers, then they can choose the medium of engagement.

Once we have the distribution model set, another interesting area is to encourage dialogue with the community about where the investment goes. Having the option for the end customers to participate in choosing which sustainability goals of their transactions will contribute can have a further positive impact on the customer's awareness of the needs and his or her influence on society. One customer may decide their transaction contribution should go towards addressing climate change, while another may feel there is much needed work to do on alleviating poverty. Having this choice will create empowerment, participatory action instead of passivity, and will enrich the customer experience by embedding the higher purpose of giving back to the community.

The bank may choose to offer this self-service sustainability contribution choice via its customer portal. Alternatively, the bank can position to allocate a portfolio classification and for each product line to assign one of the sustainability goals.

We acknowledge that these are not easy tasks and will require conversations about how to execute them, and who should decide the priorities. We also acknowledge the risks, if each bank decides for each destination country how and to what extent the money will be spent on a particular sustainability investment, irrespective of the local country's own policies and SDGs goals. Conflicts of interest could therefore potentially arise. The solution could either be that such choices are left to the individual customer making the contribution, who would choose which cause to support, or the financial institution would be required to collaborate with regional partners and local governments as an enabler to attain their SDG objectives and allocate accordingly.

Sustainability trends

We also see a trend in examples of crypto currencies which support sustainability. This is an opportunity for the industry to take a lead; for instance, initiatives outside the mainstream financial sector include the AFRO Foundation, which invests in sustainability and has created the AFRO crypto currency. Another example in the financial sector is the rise of digital currencies issued by central banks. A new joint paper by SWIFT and Accenture looks at the opportunities and challenges of central bank digital currencies for international payments, sets out practical requirements for the adoption of digital currencies at scale, and outlines how SWIFT can support the financial community as new solutions are developed.

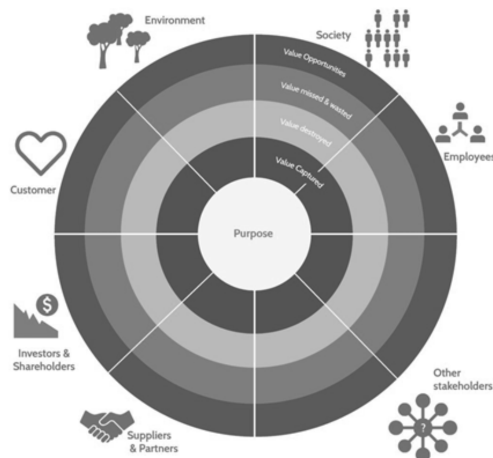
Measure and monitor sustainability goals

With SDGs, we argue that the important element to consider is how these goals translate and embed into the organisation's business model. The following model provides an example of how an organisation can map value onto their business model.

Such a tool can help users to:

- Understand the positive and negative aspects of value in a network of stakeholders, measured against the sustainability goals.
- Identify conflicting values, where one stakeholder's benefit could negatively impact another stakeholder.
- Identify opportunities for

Table 2: Value mapping tool. Source. Bocken, Short, Rana, Evans (2013)



business model redesign, especially to improve societal and environmental impacts.

It is simple to apply the value mapping tool to a business. Each ring in the diagram represents a different brainstorm. During each brainstorm, the following "stakeholders" need to be considered:

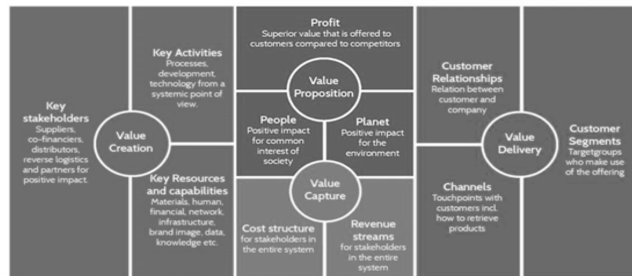
- Customers– perceived and actual benefits and negative impacts. A business may want to break this down into different customer segments.
- Network actors – the firm and its supply chain responsible for creating value. This may be broken down into key suppliers or partners and their impact on sustainability, ensuring an end-to-end view of the supply chain.
- Environment – benefits (e.g., afforestation) and negative impacts (e.g., air pollution).
- Society – benefits (e.g., improved health) and negative impacts (e.g., poorer working conditions).

Regulation: fostering sustainability in banking and financial services

Regulatory and journalistic accounts are replete with headlines about the heavy fines that have plagued the financial industry recently for non-compliance with anti-money laundering (AML), Know your Customer (KYC) and sanctions regulations. In this regard, 2019 was a record year. The fine value issued in that year by the UK's Financial Conduct Authority (FCA) for transaction reporting failures, for example, was 55 times the value of all MiFID II fines issued in 2018 ($1,480,942).

This rise in sanctions combined with a surge in regulatory rules

Table 3: Overview of business model elements in 'sustainable business model canvas'.



and financial crime has forced the financial industry to embrace regulatory technology, commonly called RegTech, to achieve robust compliance. From this viewpoint, regulation is understood to serve compliance needs regarding established data security, privacy, money laundering (ML) and counter-terrorism financing standards.

However, in an industry confronted by fast-changing revenue and consumer satisfaction demands driven by digitalisation, regulation cannot only be about avoiding sanctions. It is also about delivering compliance while ensuring satisfying customer experiences. More importantly, regulation concerns embedding ethics and building trust in the financial industry by ensuring product and service propositions meet customers' needs for service to others.

Consider in this context the digitalisation of the banking industry, which has created fresh possibilities to enhance customer experience by managing relationships with service providers and using digital platforms for service and product delivery. At the same time, these developments have increased ethical concerns about a range of issues associated with the use of new technologies. They include transparency, justice and fairness, non-maleficence, responsibility, privacy, beneficence, freedom and autonomy, trust, sustainability, dignity, and solidarity. Addressing these issues through a robust system of regulation that monitors ethical compliance underpins trust in the banking and finance industry's ability to help deliver a sustainable future.

Returning to this paper's core proposal, should the financial industry be regulated against ethics, social, environmental, and other sustainability criteria? The answer from our standpoint is yes. We see a key role for regulation in expediting the adoption of sustainability and ethics by the financial industry. In this regard, the EU Sustainable Finance Disclosure Regulation (SFDR) is a step in the right direction, obliging financial market participants and advisers to disclose to clients the integration of sustainability risks in their investment decision making processes or in their investment or insurance advice.

The EU Sustainable Finance Regulations, the EU guidelines on ethics in Artificial Intelligence (AI) (European Union, 2021) as well as emerging industry guidelines regarding the ethical use of new technologies like AI and 5G further reinforce sustainability, given the impact of new technologies in the banking and financial services industry. This baseline can be broadened to include other benchmarks such as the UN's SDGs.

Ultimately through thought leadership, regulation encourages discussion on ethics and sustainability and ensures collaboration across the private sector, consumer groups and academia. This engagement will enable the development of an

ethical code which observes the norms of service to others. When applied to compliance monitoring and regulation, such a code will in turn enable the banking and financial services industry to achieve sustainability plus a competitive edge in the race to win trust and customer satisfaction.

Financial Industry Collaboration

In a similar fashion to how the UN rallied many countries collectively for the common cause of sustainability, we see a similar need for central, neutral facilitation in the financial eco-system. An institution such as SWIFT, as a cooperative society in the financial sector, can act as a catalyst by leveraging its platform to encourage the financial sector to exchange best practices and ideas around sustainability, create partnerships with NGOs, and even include smaller non-financial organisations that are making an impact on the ground.

To ensure the SDGs are successfully adopted by the financial sector, we see an opportunity for SWIFT to further partner with the UN and regulators to create collective guidelines and common ways to measure sustainability scores, integrate distribution of investments in transaction landing zones, and explore avenues to advance the 17 SDGs and develop additional goals beyond 2030. In addition, this international collaboration should work to achieve commonly accepted benchmarking for the financial sector to measure progress in meeting sustainability targets. These are important steps that the financial sector needs to consider in ensuring sustainable sustainability in the 21st century and beyond •

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Conduct Capital Buffer

Ethics & Trust in Finance
Global edition 2018-2019

Finalist

Monika Swaczyna-Pruchnik
Poland
*Ph.D. Candidate, Polish Academy of Sciences *, Warsaw (Poland)*

* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

The aim of this essay is to propose a regulatory instrument rewarding ethical behaviour in the banking sector.

It is divided into the following parts:

i) Rationale for a regulatory-driven incentive for banks to behave more ethically;

ii) Key findings in literature about conduct and ethics in finance and how I define them in relation to banking;

iii) Proposal of a measure to evaluate the conduct of banks;

iv) Discussion of how to promote conduct effectively by regulatory stimulus;

v) Proposal of a Conduct Capital Buffer;

vi) Brief discussion on credit risk related concerns of the Conduct Capital Buffer.

I mostly used the example of the Poland for illustration purposes while developing the concept of the Conduct Capital Buffer. The key findings and ideas seem to be universal in nature and should be applicable to most countries with a developed rule of law.

The unethical world we live in

The issue of ethics in banks is quite complex. As demonstrated during the last global financial crisis, the conduct of banks significantly deviated from the desired ethical standards. This was a key point of interest for a number of newspaper articles (Irwin, 2014; Wild & Glover, 2018), books (McCormick & Stears, 2018; Koslowski, 2011; Villa, 2015;

Aragon, 2010; Carboni, 2011), films (Wolf of Wall Street, 2013; The Big Short, 2015; Inside Job, 2010) and even Master's theses (Turner, 2010) and Ph.D. dissertations (Tischer, 2013).

The behaviour of banks in recent years significantly deviated from the desired ethical standards. The scale of financial fees imposed on financial institutions has also been growing. In Poland, the lack of research devoted to conduct makes the assessment of the level of compliance impossible, especially since it would be too superficial to link this assessment of individual banks solely to fines imposed by the Polish Financial Supervision Authority (PFSA). At the same time, it seems that the current lack of conduct regulations in the narrow sense does not have a sufficient, direct impact on the actual operations of banks and supervisors lack the competence to force financial institutions to behave more ethically.

In the United Kingdom, for several years now, an innovative study has been conducted to measure the level of conduct compliance in credit institutions. For the mechanism for awarding ethical behaviour to be effective, it must motivate the actions of the bank's shareholders rather than its employees.

A comprehensive study by the Conduct Costs Project Research Foundation (CCPRF) has revealed distortions that show how the banking sector diverged from the common standards of morality[1]. In the period 2012-2016, the 20 largest banks in the world, employing a total of 2.3 million people paid £300 billion in fines for misconduct, equivalent to about 70% of Poland's GDP. Contrary to popular belief, misconduct consisted mostly of faulty internal processes and procedures, not deliberate frauds by individuals in cases that were often covered by the media, such as that of the Credit Suisse employee, Patrice Lescaudron. The majority of fines resulted not from fraud or market abuse (which only accounted for 6% of all fines, including the LIBOR scandal), but from banks' persistence in virulent practices towards their customers, due to their focus on profit and vulnerability to moral hazard. Thus mis-selling issues, based on misleading customers, was the root cause of the majority (85%) of cases.

Pure market forces fail to promote ethics in banking

Perhaps the most significant fact is not the size of the fines related to misconduct but the impression that top management at banks do not fully appreciate the negative impact of misconduct on the financial performance of their institutions. Costs incurred to repay fines and redress or remediation of misconduct amounted to an average of 10% of all expenses incurred by banks between 2012 and 2016. If the analysed banks

1 Conduct, Culture and People Research Foundation: www.ccpresearchfoundation.com/index, (accessed 14 January 2019).

had not been compelled to pay fines, their profits would have been on average 21% higher, with annual Return on Equity (ROE) increased by 3 percentage points.

Reputational cost, another hidden cost of misconduct, is also worth highlighting. Armour et al. (2010) estimated that this type of cost could be almost nine times the size of fines. Given this finding, one might suppose that managing a bank in an ethical way would be promoted by market forces – in particular, by shareholder pressure and pressure on bank management to minimise costs and maintain a good corporate image. A potential explanation for why this is not the case is the short-term mindset of shareholders and senior bank management, as noted by Rappaport & Bogle (2011), Dallas (2012), Milbradt & Oehmke (2015) and Repenning & Henderson (2010).

This observation, as well as the review of the literature, suggests that the market is not driving banks' behaviour in a more ethical direction, as desired by customers and regulators. This leads me to argue in favour of a new regulatory solution, aimed at rewarding the ethical behaviour of banks. It would consist of a six-month assessment of the ethics of banks in Poland, conducted on the basis of a survey and a qualitative study which would be an extended version of the cited study from the UK. Based on the results of such a study, the PFSA could reduce or increase the soft capital requirement by one percentage point.

Step 1: Defining an ethical bank

Over the years, many academics (Murdoch, 2015; Perezts, 2015; Koslowski, 2011) have attempted to produce a definition of the term conduct or ethics in banking, with reference to ethical standards devised by ancient philosophers and applied to today's financial world. However, no universal agreement has been achieved on what ethical behaviour in banking or what banking conduct really mean. Even the Banking Standards Board, the Conduct Costs Project Research Foundation (CCPRF) and Reuters in its Culture and Conduct Risk report, fail to provide a clear definition or set of benchmark requirements. Instead, they focus on policy and management guidance.

In addition, in most (if not all) jurisdictions, information on conduct and ethics in finance is significantly dispersed in the current regulatory environment, without a single point of focus in a dedicated legal act, regulation or recommendation[2].

2 The current Polish examples of recommendations containing conduct-related provisions are: i) the Code of Banking Ethics (PBA); ii) Recommendations of the Banking Ethics Committee of the Polish Bank Association (PBA for older customer service (PBA); iii) to a certain extent, Corporate Governance rules for supervised institutions (PFSA). At a European level, conduct-related provisions can also be found in many EU secondary laws, including: i) MIFID; ii) CRR/CRDIV; iii) EMIR; iv) guidelines and standards originating from EU agencies such as EBA and ESMA).

The lack of a harmonised approach or even a basic, agreed definition makes it all the more difficult for markets to implement and value ethical standards.

However, there is a consensus that, due to their social role, banks' attitudes to conduct should put the customers' interest before their own profits. There is a rich literature on whether ethical behaviour has a financial impact on banks. Marlene (2015), Halamka & Teply (2017) and Herrera et al. (2016) used econometric tools to analyse differences in financial performance between ethical and standard or non-ethical banks. They came to the same two conclusions.

First, conventional banks show higher profits in the short term, which is aligned with the problem of short termism. However, in the long term this difference from ethical banks becomes smaller. Second, ethical banks tend to be less risky and more stable with ROE volatility lower than their standard peers. Similar conclusions were drawn by Mascu (2010) and Climent (2018) in their case studies on selected banks.

In this essay, I propose the following way of looking at conduct in banks. It is ethical behaviour as understood by doing the right thing towards three distinct groups of stakeholders: clients, employees and shareholders. This is in line with what Plante (2004) suggested.[3]

Step 2: Assessing if a bank is ethical

Since 2015, the UK's Banking Standards Board (BSB) has conducted an annual survey of UK banks[4] to assess awareness and compliance with corporate conduct. The BSB undertakes a general survey of bank employees, qualitative, in-depth analysis of focus groups, and interviews with management and supervisory boards. The aggregated research results are highly publicised in the UK. Many organisations refer to them, including the Financial Conduct Authority (FCA), the Bank of England (BOE) and the UK government.

While the results are not binding for banks and do not require them to take any regulatory actions, I am aware from my own professional experience that they are discussed in detail during bank management meetings. They form the basis for taking internal steps to improve banking processes. In addition, the BSB results initiate analysis, including whether current incentive models for employees are appropriate

3 Professor Thomas G. Plante, Stanford University School of Medicine, author of *Do the right thing: Living ethically in an unethical world* (New Harbinger Publications, US, 2004. There is not space in this paper for full analysis of Plante's definition.

4 The public version of the report, containing aggregated results, is published online: https://www.bankingstandardsboard.org.uk/annual-review-2017-2018/. However, the BSB does not disclose data for individual banks participating in the survey.

and whether the institution generally behaves in an ethical manner.

Therefore, drawing on the BSB surveys, I would suggest a wider-ranging assessment of banks' conduct based on three similar tests for the three stakeholder groups that I identified above: clients, employees and shareholders. The principles of the present proposal are universal and should be applicable to any country or region. The assessment would take place every six months and would be carried out by the local Financial Supervision Authority (FSA). The questionnaire would grade bank's internal culture, procedures and policies, business priorities, suitability of products and services provided, and customer service[5].

The costs of the survey would be covered by banks participating in the study, subject to the principle of proportionality[6]. The results and the ranking of banks' performance in terms of conduct would be publicly available and all cases of misconduct would have regulatory implications.

In order for banks to be motivated to act ethically, all stakeholders should share a common purpose: bank employees, who respond to their managers, who in turn at the most senior levels respond to their superiors or principals, namely the shareholders. This interpretation of a corporation, where the ultimate purpose is to maximise shareholders' wealth, is known as *shareholder primacy*.

Step 3: Designing the regulatory stimulus

I therefore argue that in order for a regulatory stimulus to be effective in promoting ethical behaviours in banks, the regulations should incentivise the top management via shareholders. .

Return on Equity (ROE) is the key indicator for shareholders, as noted by Damodaran (2008), Maverick (2019) and repeatedly by the investor Warren Buffet since 1987. It is considered to be a measure of how effectively management is using the company's assets to generate profits. The ROE consists of profit (numerator) and equity

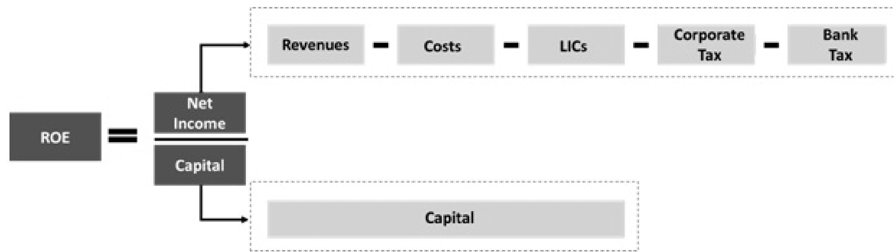
5 In particular, processing complaints, fair and clear communication with customers, remediation and redress.

6 Options may include the number of customers, size of the bank or share in the market.

Figure 1. Shareholder primacy

Source: Author's presentation.

Figure 2. ROE analysis



LICs are Loan Impairment Charges. In Poland, banks also pay bank levies.
Source: Author's presentation.

(denominator). The higher the ROE, the more attractive a company is for investors. To obtain a higher ROE, institutions can increase profits or reduce the equity. The detailed breakdown of ROE is provided below.

For banks the equity part is driven by the regulator. In simplified terms, these are assets or capital that the bank must retain in case a crisis occurs. However, the structure of indebtedness, which is reflected in banking, also includes risk-weighted assets (RWA), which allows a risk weight to be assigned to specific groups of assets. The aim of this indicator is to emphasise that not every bank loan is equally risky. The level of capital required depends on the level of RWA.

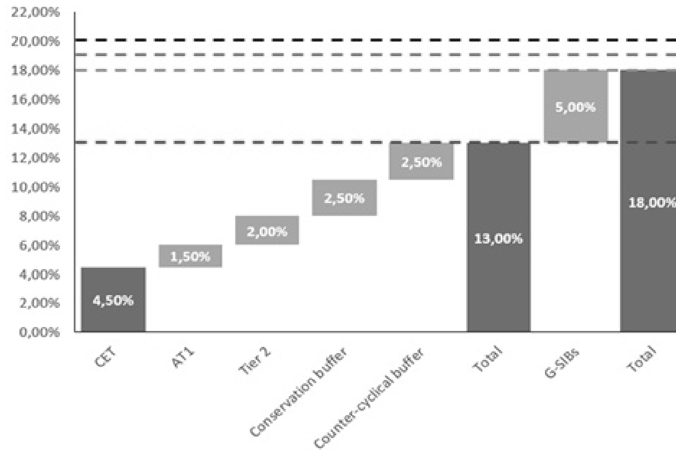
For the largest banks[7], the required capital can be up to 18%. However, for most banks globally, the requirement varies between 12-13%. Some analysts and bankers suggest that current capital requirements are already too high and render business unprofitable. However, research suggests that banks would be able to remain profitable and generate value for shareholders if their combined capital requirements were 18% (International Monetary Fund, 2013), 19% (Bank of England, 2011) or even 20% (Bank of International Settlements, 2010). This indicates that there is room for potential additional capital surcharges on banks.

Based on the ROE breakdown, two "spots" have been identified which are worth considering for the introduction of a regulatory stimulus to drive desired ethical behaviours: either the regulatory impact on profits (numerator), or capital (denominator).

First, I discuss profits. The obvious idea for a regulatory impact would be an additional levy on banks' profits which depended on the degree to which a bank had acted unethically. However, the disadvantage of this solution is that

7 Defined by the international Financial Stability Board as Globally Systemically Important Banks (G-SIBs).

Figure 3. Capital Requirements – an overview



Lowest line: Requirement for most banks
Third line: Requirement for largest banks at maximum level at which banks would be profitable according to the International Monetary Fund (IMF)
The two top lines: Maximum level at which banks would be profitable according to BOE and Bank of International Settlements (BIS).
Source: Author's presentation.

it would be an inherently negative stimulus. In order for a regulatory impact to be effective, it should not be a punishment, but a reward for banks with a high level of good conduct. Such an approach is supported by Coglianese & Mendelson (2010), who emphasise that effectiveness and compliance with regulations are heavily dependent upon incentives and rewards.

The second area is capital. Here, the suggestion would be a change in capital requirements (reduction) which allows for a more positive stimulus. Such a measure would give shareholders a goal to pursue (lower capital requirements result in more profits for distribution to investors) rather than a penalty to avoid (bank levy).

Step 4. Putting pieces together

Based on the above considerations, I propose that a Capital Conduct Buffer (CCB) tool is introduced. It would be a regulatory solution modelled on the own funds requirements under the EU's Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRDIV). An additional capital requirement of 1% of risk-weighted assets (RWA) would be imposed automatically on all banks in a jurisdiction. For the purpose

of demonstration, I will focus on Poland as an example but the below are universal and could be applicable in most, if not all countries.

Based on BSB surveys, I suggest a broader evaluation of bank behaviour based on three similar tests for all three stakeholder groups: customers, employees and shareholders. The evaluation would be conducted every six months by the local financial supervision authority. The survey would assess a bank's internal culture, procedures and policies, business priorities, the adequacy of products and services, and customer service. As discussed earlier, the cost of the survey would be covered by banks participating in the survey, subject to the principle of proportionality. The results and ranking of banks in terms of conduct would be available to the public, and all cases of misconduct would have legal effects[8].

8 The UK survey is not public, as it is a bottom-up initiative of banks themselves. In the proposed solution, CCB would be a regulatory requirement and would ensure banking sector transparency. It is noteworthy that since 2018 the UK's Financial Conduct Authority (FCA) and Competition and Markets Authority (CMA), have obliged banks under the BCOBS7 regulations to publish Service Quality Indicators and FCA Metrics. These measures disclose the quality and speed of rendering individual services such as issuing or blocking bank cards and drawing down credit facilities. UK banks must also publish the results of survey questions for bank customers in several basic categories: for example, "Would you recommend this bank to your business partners/family members?" Banks must display the results in a visible place at each branch and publish them on their websites.

Based on the survey results regarding the bank's conduct, it could enjoy a reduced additional capital requirement, as a reward for high ethical standards; or suffer an increased requirement, as a penalty for low standards. This solution would enable banks to be ranked in three categories:

1. **Ethical banks**: Institutions with top 10% scores. These institutions would have a reduced CCB value, which would earn them a reward for ethical behaviour.
2. **Conventional banks**: Institutions without any outstandingly ethical behaviour but not pursuing bad practices either. They would not be rewarded for good conduct, but as they do not violate the law, they would not suffer any penalties or costs for misconduct.
3. Unethical banks: Institutions subject to judicial or administrative proceedings, or which have otherwise displayed misconduct. This category would suffer a double penalty. Their CCB score would be increased and, additionally, they would be obliged to pay penalties and be liable to judicial or administrative sanctions.

An incentive designed in this manner would have a significant impact on ROE and would therefore motivate shareholders to put

pressure on management to develop strategies that would make banks behave more ethically. While the inspiration for such survey is taken from the UK's BSB, the suggested assessment would feature the following differences:

- It would be carried out once every six months
- The full results would be available to the public i.e. the banks' ranking in terms of conduct
- It would be carried out among both bank employees and customers
- It would have regulatory implications

CCB: How it would work

I suggest that in Poland the survey should be developed following industry consultations with banks, the PBA,[9], the central National Bank of Poland and the PFSA. . The leader of the survey design should be the Polish Competition and Consumer Protection Office (CCPO),[10] the body which most closely compares with the UK's FCA. The survey among banks would be carried out by the PBA. Based on the results of the survey, the PFSA would decide every six months whether to raise or lower the soft capital requirement by one percentage point on the total capital requirement imposed on a bank[11].

Such a procedural design would ensure the cooperation and mutual control of all communities concerned, making the most of experience, knowledge and different perspectives on particular cases. This is important, given the lack of clear guidelines or an agreed, tight definition of conduct.

The choice of the supervision body for the banking market as the ultimate decision-maker is dictated by its knowledge, access to information, competence and mandate to regulate capital requirements. The risk of a non-objective approach and excessive arbitrariness must be noted. However, it should be emphasised that over the years, institutions such as banking supervision authorities, especially in developed countries, have employed highly qualified personnel and displayed strong resistance to external influence, regardless of whether they are a separate institution or integrated with the central bank (Barth et al., 2006). Nonetheless, in order to ensure the maximum level of objectivity, this paper proposes the

9 The PBA already conducts surveys examining the quality of services. However, they are not comprehensive or binding.

10 The CCPO and the Consumer Ombudsman also undertake similar activities in fields such as unfair market practices, as defined by law. However, they are not specialised regulators of the financial market and lack the analytical competence, information resources and financial sector data to detect and prevent banking risks...

11 The author does not propose detailed questions or a design for translating survey results into an increase or a reduction of the requirements. These elements are beyond the scope of this study and would need to be clarified following several months of industry consultations.

involvement of the banking industry through the PBA and the CCPO, which, as a separate institution, could balance any potential bias by the PFSA.

One possible objection to the proposed solution is that it provides for the simultaneous introduction of conduct measurement, publication of results and implementation of penalties and rewards. Such a workload would be very difficult for banks to manage in a short period of time. An alternative solution could be to stagger the approach, starting with measuring and publishing the conduct level in banks' reports and statements, with an expectation on investors and customers to respond first.

However, as noted above, the current experience indicates that the market does not measure the level of conduct effectively. I therefore doubt the real impact of the requirement to publish a bank's conduct level on the actual decisions of investors, on the bank's market capitalisation and then on its operations. It is also rare that a bank's customers read its financial statements, so this information would in fact not be visible to them.

CCB would not make banks riskier

The concept of reducing capital requirements based on non-financial features is already discussed in relation to green finance. It was suggested by the European Banking Federation in 2017 and is being considered by the European Commission (2018) and the FCA (2018). Some commentators such as Matikainen (2017), suggest that such a solution might lead to additional risk-taking by banks. I accept Matikainen's point that capital is for loss absorption and that lowering its level to promote specific investments like *green finance* can threaten a bank's financial sustainability. Yet I believe that the CCB approach can avoid this risk.

First, as noted before, empirical studies show that ethical banks – the desired outcome of the CCB - are more financially stable. Second, my proposed surveys would only evaluate ethical behaviour. ,They would not target specific financial activity, such as promoting credit to people or institutions based on purely non-financial features like gender, locations, or types of activities. •

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Ethical Aspects of Bank Resolution

Ethics & Trust in Finance
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Finalist

Aleksander Kowalski
Poland
*Compliance Manager (Investment Banking), Bank Pekao S.A. *, Warsaw (Poland)*

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

To encumber other stakeholders besides shareholders and taxpayers with the absorption of bank losses has a strong ethical underpinning. A new legal instrument in the hands of supervisory bodies, known as resolution, will allow a fairer distribution of bank losses among various entities. At the same time, it raises new questions at the interface of finance, law, and ethics. It is therefore of fundamental importance to define the notion of "public interest" as a prerequisite for the initiation of a resolution action. This question needs to be addressed with reference to basic ethical standards. Otherwise, resolution will only be regarded as endorsing state aid to failing banks.

A bail-out too far

In the spring of 2013, riots that hit the streets of Nicosia, Cyprus, made the world aware of the need to revisit the concept of "privatising profits and socialising losses" which became notorious in the aftermath of the 2008-09 financial crisis. This method of functioning in the financial sector went much further than "just" the so-called real economy[1] and affected the public finance systems of Ireland, Portugal, Italy, Spain, Greece, and Cyprus.

The angry crowds protested against being the ultimate fall guys for the recapitalisation of banks. In the meantime, it had been noted

1 According to (Stiglitz, 2001) "...failures in the banking system have strong spillovers, or externalities, that reach well beyond the individuals and firms directly involved."

that there was an extensive group of entities that had earned a huge income from banking activities. They had weathered the crisis almost intact, without accepting any burden of the losses, unlike taxpayers. That group was the supplier of financing for banks; that is, investors purchasing bank debt in the form of bonds. During the financial crisis of 2008-2009, it was the fear of turbulence on global debt markets that led governments to embark on socially unpopular programmes that extended state aid to banks. That situation was seen as socially unfair and resulted in further accusations of unethical conduct by both banks and politicians.

During the Cyprus crisis, it was done differently. The burden of bank losses was shifted to bondholders and depositors who held deposits exceeding the covered €100,000. Consequently, instead of traditional state aid, known as a "bail-out",, part of the banks' debt was written down as a so-called "bail-in". By distributing the burden of losses among a larger number of investors, including both shareholders and bondholders, it was possible to protect the interests of the least experienced providers of financing for banks: namely, depositors whose funds were covered up to €100,000.

As a result, a fairer and ethically acceptable solution was proposed. Interest collected by bondholders in the form of a coupon payment was nothing more than a margin for the issuer's credit risk that they bore. Therefore, if these investors accepted such a risk for compensation, they could not expect their investment to be risk-free; that would have been the case if Cypriot banks had received state aid. It is common knowledge that there is no such a thing as a free lunch; someone must always pay for it. In this case, it would have been the state or taxpayers.

No risk, no risk premium

Acceptance of the issuer's loss not only by shareholders but also by creditors in the form of bondholders and depositors therefore has a strong ethical underpinning which is additionally supported by company law. According to the widespread theory of nexus of contracts, a company is a combination of contracts between various stakeholders: shareholders, managers, creditors, contractors, employees, and so on. Based on that theory, shareholders are perceived not so much as the "economic owners" of the company but as one of the capital providers. Shareholders, as equity providers, are one of the categories of company stakeholders next to debt providers (debt capital) and human capital in the form of employees.

The situation of equity providers is specific, given the order of settling claims made by providers of various forms of corporate financing. Shareholders occupy the last place in the hierarchy of creditors: their claim is subordinated ("junior")

to all debt claimants. In other words, shareholders are the most subordinated creditors, who are only entitled to the final, "residual" claim against the property of a dissolved or liquidated company. The claim is settled only after fixed claims by other entities have been satisfied.

This means that shareholders, who are in a sense "internal creditors", can seek settlement of their "residual" claims only from the assets remaining after satisfying the "real" creditors. It follows that shareholders bear the final, "residual" risk which is much greater than that faced by the "real" creditors of the company. A correlative for greater risk is the increased risk premium manifested in the entitlement to have a share in the entire net profit earned by the company.[2] A means to mitigate this risk is a constraint imposed on the management board that other corporate bodies must give their consent for specific company operations to be effective.[3]

2 This does not change the fact that the payment of a dividend is not certain; provisions in force enumerate the financial resources (balance sheet items) that can serve dividend purposes. See Article 348 § 1 of the Code of Commercial Companies and Partnerships, § 233 AktG (Mäntysaari, 2010).

3 (Mäntysaari, 2009) found that "in other words, the fact that shareholders are holders of certain subordinated claims makes them residual claimants. The company may have received equity capital from some shareholders. It does not follow that this would make shareholders the true masters of the company."

Am I my debtor's keeper?

At the same time, the company's supervisory board is supposed to take care of the long-term interest of the company as a product of the collective interests of particular stakeholder groups, rather than the short-term interest of shareholders. Therefore, if such protection, previously afforded to the company's shareholders, is extended to cover other groups of stakeholders, it should also be fair for some of these stakeholders to carry the burden of absorbing company's losses. This conclusion seems justified in relation to some bank creditors, especially buyers of uncollateralised debt, given the character and significance of banks for the economy. Such entities, mainly institutional investors, provide banks with debt financing on a massive scale while not being able to exercise the right to vote at general meetings.

For many years, attempts have been made to reduce the extent of the so-called rational apathy of institutional investors purchasing stock in public companies. These investors, in particular index funds, provide capital financing to public companies. However, they usually do not attend general meetings, due to their limited participation in the company's share capital. Such an attitude has been rightly criticized as unethical, since it involves profiting from investment without any thought given to the decisions taken by the company

or responsibility through active participation in general meetings. This passive attitude is popularly referred to as "foot voting"; if they do not approve of the board's activities, investors simply "quit investment" by disposing of their shares.

Similar objections involving unethical conduct are raised against institutional investors that provide debt financing by purchasing bonds. Hence, making these investors assume the risk of absorbing bank-issuer losses has a disciplinary effect aimed at prompting the buyers of debt to pay more attention to the issuer's operations. The investor-issuer relationship is at present completely anonymous due to the public nature of transactions. It could evolve towards a standard legal relationship between the creditor and the debtor. Facing the real risk of losing the granted loan, creditors would keep a more watchful eye on the debtor's business model and operations. If their assessment was negative, institutional investors might withdraw their investment in the issuer's financial instruments.

This assessment would also take account of the ethical dimension of the business. For many years, some investment funds have defined certain types of business sectors as unethical: for example, weapons, tobacco and gambling. Such sectors are therefore not considered for investment. In recent times, given the wave of concern about global warming and the natural environment, some investment funds have stopped investing in coal companies: for example, Norway's global and national pension funds. .

Increased engagement in issuers' affairs by institutional investors, including bondholders as well as shareholders, fits the process of corporations reclaiming their ethical image and responding to rising pressure for corporate social responsibility.

No more bail-outs, unless…

None of the above changes the fact that the bail-in of the bonds of Cypriot banks in 2013 was a very innovative measure which to some extent was implemented *ad hoc* rather than because it was anchored in the existing legal framework. That framework, currently effective in the European Economic Area (EEA) through the bank recovery and resolution directive,[4] was only in its infancy in 2013. Certain specific themes can be identified which underly the legal regime of the EU's Bank Recovery and Resolution Directive (BRRD) and which are somewhat excessively summarised as "no more bail-outs." At the G20 meeting in Pittsburgh in 2009, as stressed by de Spiegeleer, van Hulle, and Schoutens (2014), the leaders of major global economies assumed an obligation "to create more powerful

4 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms.

tools to hold large global firms to account for the risk they take... and to develop resolution tools and frameworks for effective resolution of financial groups to help mitigate the disruption of financial institutions failures and reduce moral hazard in the future."

Direct reference to moral hazard shows the ethical basis for bank resolution under the BRRD. World leaders clearly indicated that it was immoral or unethical for financial institutions to assume too high a risk and then collect premiums on that basis, while having recourse to state aid from taxpayers in the event of a crisis. However, the BRRD legal regime does not completely prohibit offering state aid to banks on the brink of failure or bankruptcy; instead, the BRRD narrows its application to exceptional cases.

A closer look at the provisions of the BRRD indicates that a resolution action has several objectives:

1) to ensure the continuance of critical functions;
2) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline;
3) to protect public funds by minimising reliance on extraordinary public financial support;
4) to protect depositors whose deposits do not exceed €100,000, meaning that they are covered;
5) to protect client funds and client assets.[5]

Of fundamental importance is the fact that a resolution action can only be initiated if it is in the public interest.[6] If this condition is not met, then the normal insolvency procedure should take its course, as was the case with bankruptcy of Poland's Bank Spółdzielczy of Nadarzyn in 2016. The shareholders were the first to carry the burden of losses, followed by other financing providers, with the exception of depositors whose deposits did not exceed €100,000. These deposits were covered by Poland's Bank Guarantee Fund (BFG), which meant that normal insolvency proceedings would involve drawing from it.

No silver bullet

The adoption of the BRRD does not on its own solve the financial issues faced by European banks. The key question that remains is how to provide banks with an appropriate capital buffer to absorb losses. Admittedly, banks were required to accumulate adequate capital for a possible bail-in.[7] However, such an extensive action is a long-term undertaking and the capital will have to be accumulated until 2023.

5 Cf. Article 31(2) BRRD.
6 Cf. Article 32(5) BRRD
7 The so-called MREL or Minimum Requirement on Eligible Liabilities and Own Funds.

Meanwhile, dozens of banks are now in serious financial trouble disadvantages, in particular in southern Europe. The political demand for urgent enactment of the BRRD, combined with the practical constraints discussed above, has finally led to the adoption of a flexible legal framework, especially with regard to the fundamental problem: When are the circumstances extraordinary enough to permit state aid to a bank?

In practice, the provisions of the BRRD appear to be so flexible that the risk of abuse and unethical conduct has not been stamped out at all. In this context, questions arise about the interpretation of the general clauses used by the BRRD:

1) How to interpret a ban on treating creditors in a way that would expose them to higher losses than in normal insolvency proceedings?[8]
2) When does the public interest actually become relevant, requiring a resolution action instead of an action under normal insolvency proceedings?
3) When do extraordinary circumstances occur that would still allow state aid to a bank on the brink of insolvency?

These clauses are general enough to create the risk of abuse and unethical conduct by banks seeking state aid), supervisory bodies and specialist resolution authorities. In particular, the latter bodies have been granted specific powers under the BRRD that allow interference with the structure of banking organisations. Given the devastating economic and social consequences of bank collapses, there are concerns that political factors might influence the final shape of resolution proceedings in the wake of a financial crisis. The possibility cannot be dismissed that decision-makers will take advantage of the flexibility of the BRRD for their immediate needs. Such decisions may be lawful, but they will invite public resistance as unethical and ultimately aimed at extending state aid to banks. There are already instances of such an approach to the application of the BRRD.

8 The “no creditor worse off” or “NCWO” principle.

Resolution in books…

A textbook example of the application of resolution proceedings is the takeover of the Spain’s Banco Popular by Banco Santander. That “operation on a living organism”, performed in June 2016, fully met the objectives of the BRRD outlined above: a bank of systemic importance was saved, losses were covered by shareholders and holders of hybrid instruments (including subordinated bonds), and no state funds were expended. However, the takeover provoked controversy because the holders of senior debt did not suffer any loss. On the contrary, the market valuation of these financial instruments increased when the news of the resolution of Banco Popular was released.

This increase outraged hybrid instrument holders who brought more than 50 legal actions against resolution authorities. Allegedly, the cancelled hybrid instruments were mainly held by foreign investors while the senior debt instruments were held by domestic ones. The situation prompted the resolution authority to cancel only hybrid instruments and, by extension, transfer the burden of Banco Popular's losses outside Spain's financial system. Whether or not the allegation was true, it should be noted that such a broad competence of the resolution authority undoubtedly created an ethical issue: the temptation to exploit the BRRD's flexibility in making decisions favouring domestic investors and thereby minimise public distress in the affected country.

There are even more troubling cases. With the European Commission's approval, Italy's government extended more than €12 billion in state aid to reduce the risk of bankruptcy at the country's oldest bank, Monte dei Paschi di Siena (MPS). The aid took the form of acquiring shares in place of cancelled stock and subordinated bonds (€4.785 billion), plus guarantees granted to another bank, Intesa Sanpaolo, to offset any losses due to the acquisition of MPS's assets. The admissibility of the aid was justified by the fact that it did not meet the criteria of "extraordinary public financial support" as defined by the BRRD. Such support can only be offered to an "institution that is failing or likely to fail;" yet in this case the aid was given to a "healthy" financial institution, Intesa Sanpaolo.

The principle "from the smaller to the greater" is one of the less robust forms of legal argument, but it seems fully applicable here. Since the BRRD confines state aid to failing institutions in extraordinary situations, it should naturally follow that such assistance cannot be offered to a financial institution in good shape.

…and resolution in action

In the case of two regional Venetian banks, Veneto Banca S.p.A. and Banca Popolare di Vincenza S.p.A., the justification for the eventual extension of state aid was the conclusion that the BRRD. did not apply to those institutions. As indicated above, a prerequisite for instituting resolution proceedings is the existence of a public interest. In accordance with Article 32(5) of the BRRD, a resolution action is treated as in the public interest if it is necessary for the achievement of one or more of the resolution objectives and is proportionate to them. Under normal insolvency proceedings, the winding-up of a bank would not meet those resolution objectives to the same extent.

In the case of the Venetian banks, they were deemed too small to play a role in Italy's financial system, so their potential bankruptcy was not a threat to the system's stability. Furthermore, neither of these banks was acknowledged to perform

"critical functions" because their lending, borrowing and payment services were available to a limited number of customers and could be taken over relatively quickly by another entity.

Therefore, the public interest criterion was not met, and no resolution action was needed in place of "normal" insolvency proceedings under Italy's national laws. Yet insolvency proceedings were initiated which did not accord with the standard liquidation procedure but followed a special procedure laid down by the special Decree of the Minister of Economy and Finance No. 237/2016 (December 2016) and Act No. 15/2017 (February 2017). These instruments met the criteria of *ad hoc* interventions adopted only to remedy one specific situation. In particular, the measures sanctioned state aid to financial institutions whose bankruptcy would have caused economic turmoil in the Veneto region if the two banks had collapsed.

Once again, legal acrobatics were employed to burden taxpayers with the absorption of losses generated by banks on the brink of insolvency. Yet since the BRRD limits state aid to large, systemically important financial institutions, it should be even more demanding when granting such aid to small, relatively insignificant financial institutions. In this instance, the response of the Italian authorities provoked indignation from the EU's Single Resolution Board; however, this did not cause the return of the received aid by the Venetian banks which would have led to their bankruptcy.

It was necessary to write down bonds as well as shares in order to extend state aid in the cases discussed above. This was extremely dubious in political terms, because the banks' subordinated debt had previously been widely distributed among small investors and advertised as a secure investment; in retrospect, a clear example of unethical mis-selling.

In 2015, the write-down of such instruments issued by a small regional bank, Banca Etruria, which held the life savings of individual investors, proved politically unacceptable. There were even suicides that may have contributed to the fall of the pro-EU government of Mario Renzi. In the case of MPS, certain individual investors were granted the right to file mis-selling claims against the bank on the grounds selling financial instruments with an extremely high exposure to risk. According to MPS's estimates, the claims cost the bank about €1.5 billion.

Appropriate product – but for whom?

Another fundamental question therefore arises: Who can acquire instruments which are subject to the bail-in mechanism? In other words, which investors should be considered sufficiently experienced at assessing the risk of a future resolution action and bail-in?

Both the Polish Financial Supervision Authority (PFSA) and Poland's Bank Guarantee Fund took a hard-line approach to the problem: for the purpose of Tier II Capital and MREL (minimum **requirement** for own funds and eligible liabilities) only subordinated bonds with a nominal value of at least PLN (Polish zloty) 400,000 should qualify.

It is clear that this stance was guided by the fear of selling such financial instruments to risk-unaware individual investors, as was the case in Italy. These concerns are well-founded, given the consequences discussed above and the assessment of such an action as unquestionably unethical. ‚On the other hand, the solution adopted by the Polish authorities is also debatable. It seems to ignore European regulations and guidance which, in this context, recommend that the suitability of a specific financial instrument for a particular investor should "only" be examined. The possibility of covering bonds with the bail-in mechanism determines their complex nature, thus making it difficult for individual investors to understand their structure (ESMA, 2015).[9] This means that "ordinary" senior bonds will also have such a complex character, because they may become subject to a bail-in.

Another issue is whether introducing such an additional requirement is ethical in itself. In fact, investment in subordinated bonds is not prohibited. Instead, the diversification of investment is made more demanding, which is the basis of investing, as outlined in H. Markowitz's portfolio theory. An investor holding PLN 400,000 would still be able to invest in a subordinated bond but would not be in a position to build a diversified investment portfolio using this capital.

In practice, the implemented solution might curb the distribution of subordinated bonds among individual investors. Yet at the same time, it would significantly increase the risk for individual investors who decide to purchase such instruments anyway. This threat is real, in particular in the face of very low interest rates. The real interest rate on bank deposits pushes investors with cash surpluses towards looking for higher-interest opportunities which involve a higher risk.

Some recent experiences in the Polish bond market clearly show that the acquisition of senior bonds by a non-financial entity such as a debt purchase and collection firm can also be very risky. Limiting the availability of subordinated bonds for financial institutions would create a market void. The providers of financing would be forced to choose purely between investing in low-interest senior debt issued by financial institutions or in higher-interest senior debt issued by non-financial organisations, which is also

9 Guidelines on complex debt instruments and structures deposits, ESMA/2015/1787, 4 February 2016, p. 9.

risky. Yet there is another possibility: investing in shares. Nobody prevents individual investors from investing in bank shares, although this is a more uncertain instrument than subordinated bonds.

Pro publico bono?

The example of the Venetian banks also highlights a serious problem regarding a broad definition of acting in the public interest. This is perhaps the most serious interpretation challenge posed by the BRRD and the price to be paid for the exceptional flexibility of this legal instrument. The definition given elsewhere says that the initiation of a resolution action is justified as being taken in the public interest when it meets the objectives of the resolution to a greater extent than normal insolvency proceedings. However, there can be several objectives of a resolution, so possible conflicts between them are not impossible.

The question that should then be asked is whether the requirement of acting in the public interest is met when the initiation of a resolution action enables the achievement of one or more of the objectives to a greater extent than "normal" insolvency proceedings; but at the same time, the resolution has an undesirable effect on other objectives. In this case, the BRRD contains only one conflict rule: the "no creditor worse off" principle.

This principle underlines that the resolution authority will be able to initiate an action that would weaken creditors' protection, even if its other objectives are met to a greater extent. No such rules are provided to cover other hypothetical conflicts. The resolution authority will thus have to be ready to provide a particularly ample and above all, ethical justification for whether in specific circumstances the initiation of resolution proceedings is in the public interest.

Resolution will always lead to the burden of loss being imposed on some entities. As a result, decision-makers will be tempted to take action to cushion the domestic financial system and national investors (in particular, individual investors) against adverse effects; .for such an attitude is unlikely to draw public opposition. Once again, it should be emphasised that there is no "free lunch" and if investors buy bank bonds then they must bear the risk, which charge a risk premium anyway. And yet, the senior debt of banks is not excluded from bail-in.

Based on the above examples, we arrive at another bitter conclusion: the use of BRRD mechanisms in Spain led to numerous lawsuits against the resolution authority while circumventing the same mechanisms in Italy did not. In other words, attempts to force investors to absorb losses proved more demanding than passing the burden to taxpayers.

Treating society as the weakest link in the economy is both unethical and has significant long-term adverse effects which should not be underestimated. Society is not

defenceless because in a democratic state voters always has the power to elect a new government. Thus, in a general election, voters voice their opinion of the current legislators and decide whether they should continue to discharge their duties or not.

Cases of abuse also fuel populist movements, which were extremely successful in the last elections in Italy. Ultimately, two years after Italy's parliament passed the law on state aid to banks, voters sent the lawmakers away. At the same time, populist parties, including those that supported leaving the EU, were given a vote of trust.

Back to square one?

The BRRD was rapidly adopted in response to the Europe-wide displeasure incurred by state aid for banks. Formally, the directive has been made effective and is binding throughout the EU. Yet the rapid enactment of the new law has proved easier than the accumulation of capital or its surrogate to finance the application of the fundamental "no more bail-outs" principle.

There will be a risk of state support for banks in "extraordinary" circumstances as long as this capital is not accumulated, , which on a case-by-case basis, may be limitless. Yet despite these imperfections, the mechanism of dividing the burden of loss among stakeholders should be considered a real and workable solution. As outlined above, the solution is entrenched in company law and, moreover, accords with broader development of increasing corporate social responsibility. With reference to ethics, it is hard not to appreciate the disciplinary role of debt: state aid diminishes debt while the BRRD preserves it.

The most positive effect of the BRRD may be to require investors (creditors) to be more attentive to the quality and resilience of the issuer's (debtor's) business model. In today's financial world, involving algorithmic trading and blockchain technology, it is difficult to believe in any relationship between the debtor and the creditor that would last more than the time it takes to type "I SELL" on a keyboard. However, recent years have shown that a financial system thus organised is sooner or later doomed to turmoil and crisis.

Perhaps it is naïve to retain, confidence in the healing power of bail-ins, yet any instrument to combat financial crises is better than none at all. For this reason, utmost care should be exercised to prevent the BRRD from becoming a legal instrument that merely rations state aid to banks. Otherwise, the exorbitant costs incurred to implement this law will be wasted and the public will feel fooled again. •

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Central Rating Index for Ethics and Trust in Finance

Ethics & Trust in Finance
Global edition 2018-2019

Finalist

Colin Sweetman
Ireland
*Management Accountant and Company Director, First Accounts SAAS Ltd *, Katowice, (Poland)*

The views expressed herein are those of the author and do not necessarily reflect those of the Organization he is affiliated with or of the Jury.

It is both worrying and reassuring that young people working in finance are encouraged to write about ethics and trust in finance today – "worrying" because it means there is a systemic issue, but "reassuring" because action is being taken to improve the situation. What is even more reassuring is that young people are not obliged to write about this topic but rather encouraged to – this point is central to this essay. Ethics must be guided by one's own understanding and urge to do the right thing. It is practised as a set of cultural circumstances and cannot be rigidly imposed as a set of rules or regulations but should rather be debated and constantly challenged, with ideals changed positively.

In *Ideas and Opinions*, one of the greatest moral philosophers of the twentieth century wrote: "A man's ethical behaviour should be based effectually on sympathy, education, and social ties and needs; no religious basis is necessary" (Einstein, 2010). In a financial context, the "religious basis" can be taken as the fear of retribution and hope of reward for acting ethically. This should not be the driving force for ethics because people tend to find loopholes and use this as a measure for behaving ethically when they are instead merely acting in accordance with a set of rules.

Challenging the *status quo*

The current ethical foundation of most worldwide financial enterprise is embedded in a set of official rules and regulations which must be adhered to. Ethical behaviour cannot be fully ensured by rules and regulations alone.

What is incorrect about our current thinking regarding ethics in finance is that it can be kept in check by either following regulation or by not following regulation. Behaving ethically should not be considered as a box-ticking exercise. This is what is fundamentally amiss with our application of ethics in finance.

If ethics is not as simple as following an ascribed ethos, then a basic definition to start with is needed. Most will assume it is the difference between right and wrong but the inherent difficulty with this is that most people have different definitions about what is right and what is wrong. Instead, describing it in a utilitarian manner would help define it better; in other words, "acting in a way that promotes and strengthens trust and confidence in mutual relations" (Osesik, 2013). It is about managing conflicting personal desires with those of related internal and external stakeholder groups. Every action in finance must consider whether the effect of that action will be beneficial to all parties involved or only to some.

The purpose of the essay is simple: to propose a new system that will work alongside current ethical legislation and guidelines. Given that ethics is complex, and that any action can be beneficial for some related parties and not for others, there is a need to create an index or "spectrum" of ethics. If consumers and investors are becoming increasingly conscientious about how companies behave, then there is a demand for commercial organisations to be scored on their ethical behaviour.

In an age where fines and penalties are no longer seen as the deterrent they should be, affording consumers and investors the choice to know how ethically an entity behaves will be far more revolutionary. This paper will discuss how such a significant change in thinking will be implemented and will also give reasons and evidence as to why it will work.

Who decides what is ethical?

Currently, many investors are unaware of how ethical a company truly is. Many investors do not even know they are investors. Take, for example, the huge number of UK employees contributing towards the national pension scheme in which they are automatically enrolled; many will not know how their contributions are being invested. If we are operating on the basis that people wish to invest ethically, then it should be their right to know this information, especially if they are "defaulted" into this position. Furthermore, if pension companies are aware of their contributors' lack of investment knowledge then it creates an impetus to ignore the ethics of their actions and instead simply invest in the company with the greatest returns.

While this is not entirely the reality - thanks in part to the increase

in demand for ethical investment - most of these pension schemes provide an “Ethical Fund” which one can choose to contribute to. NEST is one of these providers and it is interesting to note that while its default “Retirement Fund” and “Higher Risk Fund” [first quarter, 2019] consist of investments in Alphabet Inc, Facebook Inc, Johnson & Johnson, Samsung Electronics, Exxon Mobil Corp. and Nestlé SA (Fawcett, 2019), their Ethical Fund does not consider these companies at all.

Given the negative press encircling some of these companies it is not surprising that they have been cut as a consideration from the Ethical Fund of NEST, but there are certain things wrong with this situation:

(i) the default fund should be the Ethical Fund (most people stay with the default option (Kahneman, 2017)), and surely the principle behind the Ethical Fund is diminished if it is also part of an entity that invests in unethical companies;

(ii) the decision to deem one shareholding as ethical or unethical is ambiguous here. No reason is given for the exclusion of certain companies from the Ethical Fund;

(iii) the need to know on what factors the decision of exclusion based, which is important because it would make for an interesting debate.

This interesting debate begins with NEST’s description of the Ethical Fund, which is “for people who want to invest in line with specific ethical or moral concerns, for example, in areas such as human rights and fair trade”. It does not just exclude companies that harm the world, its people or the environment; the fund also proactively invests in organisations that make a positive contribution to society (Fawcett, 2019). The even more interesting aspect is that, since launch, the annualised total return of the Ethical Fund has been 10.3%, while the default Retirement Fund has only returned 8.8% over its life. This would suggest that there is no direct benefit to acting unethically as an entity. In fact, we might be witnessing a shift towards making it beneficial to invest in conscientious companies.

How too many rules can cloud our moral compass

This last paragraph suggests that we are already shifting our attitude to a more integral and holistic approach towards what can be deemed ethical. This is in contrast with the last 10 years of post-financial crisis fallout of strict external regulation, which has not been successful in achieving the systemic stability it promised. Kaptein argued that there could be an “optimum number of rules after which an organization becomes riddled with them” (Kaptein, 2012). Beyond this optimum amount of rules, extra regulation will only be

damaging, as more effort is put into abiding by the rules at the expense of operational effectiveness and ethical behaviour (Osesik, 2013). Too much regulation only leads to complexity and ambiguity, rather than raising the level of morality: "Modern finance is complex, perhaps too complex. Regulation of modern finance is complex, almost certainly too complex … As you do not fight fire with fire, you do not fight complexity with complexity" (Haldane & Madouros, 2012). This is proved by the actual size of published regulation, which is supposed to guide our morality, the first and most famous of which being the Ten Commandments, which have survived more than two thousand years. Compare this with a more recent example: the 1933 Glass-Steagall Act, written and designed as a response to the Great Depression, which at 37 pages has been perused with economic stability for over 70 years; or even the US Bill of Rights, that most influential and long-standing of modern constitutional documents, which fits on a page of A4. Contrast this with the latest financial crisis, bringing a remedy of some 849 pages and more than 27,270 new regulatory restrictions (Zuluaga, 2018).

If an official regulation needs to be so detailed as to take every single possible infringement into account, then it robs the person of their ability to think independently and morally. Furthermore, it causes them instead to look for ways around the rules, which will then be justified as "moral". Following rules while searching for ways to exploit an opportunity is still unethical, but it is ever more difficult to illustrate as such if they can be seen to be acting within the law. Ethics should always return to self-criticism and inner-reflection: "is the action I am about to take going to be beneficial to myself only and damage others or is it mutually beneficial?" More regulation actually reduces people's ability to think critically about their own actions (Osesik, 2013).

Ethics in finance is currently limited mostly to two things: our own cultural upbringing, and multiple pages of regulation. In certain professions, such as accountancy, there is an emphasis on following a code of ethics, but unfortunately this does not apply to all financial professions. This leads to many companies confusing acting ethically with legal compliance. They simply follow measures and procedures imposed on them which undermine the ethical spirit trying to be achieved, as people will just consult legislation rather than their own conscience when judging what is right and wrong (Osesik, 2013). Ethical decisions should be guided by one's inner moral compass, built over years of cultural experience, and challenged. It is an all-inclusive debate which can only be upheld if its principles are constantly disputed and consequently bettered. To accept the *status quo* is to deny personal agency.

The link between morality and free will

We think of ethics as a constant set of formal standards and rules to religiously follow in order to remain safe. As previously explored, it is possible to both follow rules and act unethically. Ching-Hung Woo argues that Einstein believed morality should be treated as a secular matter of bringing dignity and happiness, as much as possible, to all people (Woo, 2015). This "maximisation" of happiness is essential to having a guiding hand in ethics and morality. The more people who benefit from any action we take, the more utilitarian it is and the more ethical it is perceived as being. All of this creates a framework for morality which can be enhanced more than a rigid set of guidelines. Woo also highlights that we have no free will when it comes to ethics; in other words, the decision has already been made by the set of circumstances that made the decision come about in the first place: "Now in the scientific framework favored [sic] by Einstein, where events unfold by deterministic laws, once an initial state of the world is completely specified, all subsequent phenomena are determined. Hence when a person faces multiple alternatives and makes a choice, the will of the decision-maker at the moment of decision was actually already fixed from the beginning of the universe. Hence the feeling of having a choice is only an illusion" (Woo, 2015). In other words, there was only one actual choice made at that point, and it was dictated by prior causes.

This is of course dangerous thinking and can condone behaviour with disregard for other parties. However, it does also make sense and is worthy of discussion. Would, for instance, the Ethics & Trust Prize have been established had the financial crisis of 2007-8 not happened? This paper has been written as a causal effect from this crisis. Given these points, it is easy to see why distinguishing between good and bad is not as easy as writing an 849-page dossier. It is better to conceptualise ethics, which is the true key to its perpetuation and lasting impact.

Even if free will is illusory, it is still important to believe that we are in control of our own actions. One experiment conducted by Vohs found that, when the control group's belief in free will was undermined, they took more opportunity to pilfer envelopes of $1 coins. It seems that when people stop believing they are free agents, they stop seeing themselves as blameworthy for their actions. Consequently, they act less responsibly and give in to their baser instincts (Caves, 2016). It is important here to reiterate that this essay argues that a disbelief in free will, and hence ethics, is as bad as rigidly following a set of rules which form legal compliance, rather than a notion of morality. A happy middle-ground lies in the space that allows the individual to constantly distinguish "doing good" from "doing bad".

"Good" behaviour as a starting point

Even the Association of Chartered Certified Accountants (ACCA) has shifted from the flawed notion that ethics can be gathered quickly from a handbook, preferring instead to now market it as "Good Behaviour"[1] rather than a "Code of Ethics". Accountants from this organisation are still expected to follow the guidelines: "Most professionals are required to comply with an ethical code – in the case of ACCA, you will be required to comply by ACCA's Code of Ethics and Conduct". However, this is stated as a bare minimum and is intended to provide the accountant with a framework upon which to build. ACCA stresses that "these principles provide a framework to guide the professional accountant" but not to "ignore your personal values when at work" (Waters, 2011).

The best definition on this webpage asks "what does it mean to behave and work ethically" and it is from this description that a professional can begin an independent ideology of what encompasses ethics in finance: "simply put, it means doing 'the right thing'. This goes beyond compliance with the law; compliance with relevant standards and regulations is also part of ethical behaviour…It also means *acting in the public interest* [emphasis added]" (Waters, 2011). The key parts of this last statement are in finding out what doing "the right thing" encompasses and how best to act "in the public interest".

1 See, for example, the ACCA webpage on Ethics: https://www.accaglobal.com/an/en/student/sa/features/good-behaviour.html

Of course, the ACCA is most interested in ethics where it specifically involves trust in the workplace, and not necessarily the other arm of ethics in finance relating to ethical investment. Therefore, when the ACCA speaks of ethics, it is really speaking of trust. The ACCA instils this trait and reinforces its importance because it has essentially given the professional accountant the power to decide how money is accounted for within an organisation, which can lead to conflicts of interest further down the line. It would be a futile exercise to deliver someone this power if they had no intention of using it correctly, circling us back to the ancient question of whether it is worse to be merely incompetent as a professional, or rather competent but evil.

The nature of trust in finance

Geoffrey Whittington writes of trust in finance:

"[It is] an essential ingredient in facilitating financial transactions. The financial reporting process helps to create trust, but it, in turn, must be trusted. Auditing and professional standards have been the traditional means by which trust in financial reporting has been fostered. Recently, these institutions have been put under great pressure

by changes in the size and scope of financial markets. The consequence is likely to be a continuing change in the nature of trust and the means by which it is supported. In the future, personal trust is likely to be substituted increasingly by trust in systems supported by regulatory bodies. This does not mean that trust is no longer important, but rather that the form which it takes has changed. The importance of trust needs to be recognised by those engaged in shaping the future of financial reporting, if they are to meet the needs of users of financial information" (Whittington, 1999).

A good example of trust in both people and systems can be observed within the recorded music industry. One such record label, Warp Records, goes as far as to refer jocularly to itself using an acronym: We Are Reasonable People (WARP). Record labels are essentially investment funds: the label gives the artist an advance of cash in exchange for future profits realised on contracted supplies of recorded music. Sometimes it is profitable, upon which, after recouping the said advance, any profits are usually split on a fifty-fifty basis. If it is not profitable then the investment is simply written-off (as with any other investment). The trust element comes from within, however, as all revenue streams are accounted by the label first, and not by the artist, as would be typical with any other supplier-customer arrangements. In the recorded music industry, the label (customer) tells the artist (supplier) how much money has been generated from sales of their music (this is repeated all the way up the supply chain). As can be seen, trust will play a major role here, as the artist is fully dependent on the royalty accountant for giving a fair and accurate report of all profit the artist is entitled to. Of course, it is written into any contract that they have the right to audit this report.Yet most artists choose to trust that the statements are materially correct.

The second issue is, as we enter an increasingly digital age, most music revenue streams are made up of micro-penny transactions multiplied million-fold. This creates the need to trust a computer system that counts and ensures precision within accounted revenue and expenditure. There is a need to ensure here that data is here to facilitate art, not threaten it (Bussinger, 2016).

In conclusion the fabric of ethics must come from within the organisation. Even if employees are determined to maintain high ethical standards, they become less ethical when corporate management adopts a profit-oriented approach compared with when it values integrity, or when no corporate values are professed (Ghosh, 2008). There is ample experimental evidence from 1979 that suggests that employees working in companies where work-life balance was emphasised and where CEOs or people in leadership positions encouraged ethical

behaviour were found to accept kick-backs less than employees who worked at profit-driven corporations (Hegarty & Sims, 1979). Therefore, we must empower financial sector employees to think critically about their ethics, instead of limiting their thinking by a set of rules.

Proposal for the introduction of an "Ethical Spectrum"

Clearly there is a need to create a scorecard of ethics for people to utilise and make ethical investments, but it does not currently exist in any defined form. Investors simply make ethical decisions based on what is available in the media, which holds two problems: the media is unfortunately often biased or misinformed, and secondly, it affords companies little incentive to try and better themselves in future. Given that the public's interest in ethical governance and ethical leadership has grown, it is necessary to enhance the importance and clarity of ethics over and above the typical response: governments tend to respond to scandal with regulations, without considering that it is the "obedience culture" which often fails in the first place (Financial Conduct Authority, 2014).

Conversely, can any financial firm be considered ethical given that its primary function is to create positive returns for its investors? Some would argue that it cannot, but the key point is that an ethical position should be considered both externally as well as internally. There should be a strict separation between financial regulators and professionals in finance. While an exchange of ideas should be encouraged, fraternisation as well as a change in employment across the divide should not. The relationship between judges and lawyers could serve as a guide (Bieber & Viehoff, 2017). This would limit any conflict of interest that could arise when making important decisions regarding an entity's ethos.

Sub-sections of Ethics & Trust Scoring

There are two main fields which this scoring can be broken down to, each with a valid motive:

(i) Trust in Corporate Governance Ratings, giving users of the scores the ability to see how well-run and well-managed an entity is;

(ii) Social & Environmental Responsibility Ratings, giving users corporate insight into how ethical an investment might be.

The value of subdividing the scoring system into two sections like this is to highlight the way in which these scores will be affected. Corporate Governance, for instance, depends on directors and employees within an entity acting selflessly and in the best interest of the related stakeholders, while Social & Environmental Responsibility will examine how the entity regards its day-to-day trade as ethical. In other words, one is internal and the other is broadly external.

Scoring Index: Trust in Corporate Governance Ratings

Once the two categories are identified, we can begin scoring the entity using an index. While there have been many attempts to measure governance from a compliance perspective, there are currently no global benchmarks with which to measure Corporate Governance standards. As a starting point, there are currently a few ratings systems which concentrate on certain categories, such as board compositions, ownership structures, compensation plans, anti-takeover devices, financial disclosures, internal controls and directors' educational backgrounds.[2]

In recent years there has been demand for ratings agencies to introduce these systems as a means of assessing the very real risk factor that a board of directors can have on an investment. The aim would not be to be merely compliant, but to be guided by the "spirit" of the ratings system. Every publicly-listed company should be part of bringing this about, in order not only to "level the playing field" but also to trickle this sense of ethics into the private sector.

The main goals of the Corporate Governance scorecard would therefore be:

(a) To facilitate the work of analysts and investors through a systematic and easy overview of all relevant issues of good governance. It is vitally important that the users of these reports understand the information contained within them.

(b) To enable companies to easily assess the quality of their governance situation. There is a need to give executive boards the impetus to succeed at becoming ethical.

(c) To allow the setting of minimum scores by investors for governance as part of general investment policies. External parties should be given the right to affect the score if they can justify the means for doing so. Internal parties can either accept this change and try to improve their situation, or challenge the verdict.

(d) To enable comparisons across industries and across countries, because we can only really assess progress when using comparative information.

(e) To be readily available to all interested parties via the internet. This can be via a paid subscription; it does not necessarily have to be free. The results should also come with a description of how they formed

2 Examples include: Governance Metrics International (GMI) Ratings, the Corporate Governance Quotient (CGQ), the Corporate Governance Score (CGS) of Standard & Poor's and the Board Effectiveness Rating (BER) of the Corporate Library (TCL).

their rating and what the index was based against (Bhasin, 2009).

The assessment criteria will be fluid, but will broadly consider three main areas:

- Composition of the Board of Directors: the Board's structure and related-party disclosures; the size of the board and its attendance at meetings; level of executive share ownership; the independence of its members; and the emphasis on communication of the company's ethos.
- Approach to External Audit: the presence of an audit committee; which audit firm is used, and if subsidiaries are "split out" to different firms; what percentage of revenue the audit represents; what are the standards for audit in the given territory.
- Effect of Key Performance Indicators on Ethics Standards: most importantly, a measure of how effective being ethical really is to the company.

This last point is important as it is vital to highlight that behaving ethically through responsible corporate governance can pay dividends in the long run, perhaps to the extent of preventing another crisis.

Scoring Index: Social & Environmental Responsibility Ratings

The next index discusses not the internal governance of an entity but rather how that entity behaves within the environment it operates. The demand for responsible investment has boomed in recent years, with ordinary investors becoming more aware of their need to protect the planet they live on. There is also a realisation that growth can only occur sustainably when there are limited resources available.

Currently, there are two agencies which have made it their goal to assess large brands based on their environmental and social impact: Ethical Consumer and Good on You[3]. There is also an index for listed companies called FTSE4Good. However, it has received criticism (ironically creating an unethical situation by trying to be perceived as being ethical) because it lists some fossil fuel companies as environmental, which merely serves to "greenwash the reputations of major polluters" (Jolly, 2019). This has led to a situation where environmentally-conscious investors are unaware that they are essentially funding fossil-fuel extraction. The FTSE4Good is owned by the London Stock Exchange which further signals a conflict of interest. It is good that the London Stock Exchange is addressing its need to be environmental, but ratings should look at clear facts with the inclusion of all related stakeholders.

3 See, for example, Ethical Consumer: https://www.ethicalconsumer.org and Good on You: https://goodonyou.eco

In contrast, Good on You is an independent ratings agency, and its model for rating is quite straightforward. The model is based on how transparent a company is regarding its supply chain; whether the company has taken several significant positive initiatives (often as leaders on one or more key issues); whether it is designed to be ethical from the ground up; and whether it has relevant accreditation or certification.[4]

Ethical Consumer uses the following method: "We score each company out of 14 and each product out of 20. We use a negative based scoring system where a company starts with 14 and then gets marks taken away if it gets criticised in one or more of our categories. There is one exception to this. Companies can score a positive mark under company ethos if they commit to certain things (e.g. Fairtrade) across their whole company group."[5] Ethical Consumer also award points for accreditation.

Conclusion

It is obvious that environmental and social awareness is consumer-driven rather than investor-driven. Steps should be taken to include the foundations of ethics that companies have used to successfully drive campaigns that result in either a company changing the way it trades, or by a product being boycotted or shunned. Investors take notice of market demand and this is how real change can occur. Compounded with the addition of a centralised ethical ratings system, there is a genuine hope that ethics and trust can be restored in finance.

The aim of this paper has been to highlight that the current approach to ethics works to a degree but is prone to collapse through hidden deterioration. It is not necessary to get rid of the current framework but there is a need to centralise and enhance it through measures which will bring about free debate. The key issue is that our current ethical grounding is based on following rules rather than grasping the spirit of the essence of what it means to be ethical. Trust should not be taken for granted. With this proposal, I hope not to keep corporations "in check" but to keep all connected stakeholders informed about how they can bring about real change with the right information. •

4 https://goodonyou.eco/how-we-rate/
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Bank Secrecy at an Ethical Crossroads

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Finalist

Brian Collins Ocen
Uganda
*LLB Student, Makerere University**
Kampala (Uganda)

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

"…sometimes, the most expedient solution to an ethical dilemma is to get rid of the person who thinks it a dilemma." (Scrivastava, 2021)

Legally and morally, a bank customer is entitled to the privilege of non-disclosure from any bank with which the customer agrees to enter into a contractual relationship. (Sealey and Hooley, 2008). This privilege for the customer, and duty for the bank, is known as "bank secrecy". It is undeniable that bank secrecy is a principle and practice that has invariably been a chief cornerstone of the bank-customer relationship universally. This is primarily because it is a feature that safeguards the customer's fundamental right to privacy (Sealey and Hooley, 2008). However, over the years, the abuse of bank secrecy has resulted in a pervasive criminal enterprise of illicit financial flows (IFFs) in the banking industry (Beer, Coelho, and Leduc, 2019). This prevalence of IFFs under the protection of bank secrecy has seemingly led regulators to find good ground to question the workability of bank secrecy (Beer et al, 2019); especially as communitarian interests such as tax justice, anti-money laundering and sustainability are at stake.

Thus, as the banking industry struggles to get rid of IFFs via the abuse of bank secrecy, an ethical dilemma lies at the heart of this struggle. Essentially, this is a dilemma in which it appears that the proponents of the classical liberal individual rights ethical theory which underpins bank secrecy are diametrically opposed

to proponents of the ethical theory of utilitarianism which underpins the communitarian interests behind the regulatory approaches aimed at combatting bank secrecy. Against this background, this essay asks whether this apparent war of values could simply be another false dichotomy and an opportunity for the hybridization of normative ethical theories? If so, we further ask who or what is to blame for this false dichotomy? Could it be that the current monomaniacal approaches to teaching ethical philosophy leave no room for hybridization are to blame?

In answering these questions, this paper explores how finance in its struggle to pull the plug on IFFs via the abuse of bank secrecy can meet the communitarian interests of society such as sustainability, tax justice, and anti money-laundering, without jettisoning the fundamental rights of individuals. This is a central consideration in normative ethics and is of vital significance for the future of the bank-customer relationship. The body of this essay is divided into three sections : (i) Part one will discuss the prevalence of IFFs via the abuse of bank secrecy, and critically, the effect of such IFFs on the sustainability agenda ; (ii) part two will cover the ethical war of values in the struggle to eliminate IFFs ; (iii) and part three will delineate how this ethical dilemma can be succesfully navigated.

The Abuse of Bank Secrecy

According to Global Financial Integrity (2018), any money that breaks laws in its origin, movement, or use, falls within the characterization of IFFs, also commonly known as “dirty money”. Over the last decade, the banking industry has been repeatedly rocked by scandals involving IFFs via the abuse of bank secrecy. They include the 2012 revelations of HSBC’s violation of the Bank Secrecy Act in America; the 2015 Swiss leaks by the International Consortium of Investigative Journalists (ICIJ); the 2018 revelations of money laundering at Danske Bank’s Estonian branch; and most recently, the 2020 FinCEN Files revelations, also by the ICIJ. These revelations, which are by no means exhaustive, have reinforced the public perception that financial institutions are inherently unethical.

Some of the revelations were merely suspicious and not firm evidence of misconduct; for instance, the FinCEN Files consisted of suspicious activity reports involving about $2 trillion of potentially dirty money. However, most of the public outcry against financial institutions has concerned proof of actual IFFs via the abuse of bank secrecy. The most notable cases are the 2012 revelations of HSBC’s violation of the Bank Secrecy Act in America, where the bank was found to have turned a blind eye to $881 mn in drug money from the Sinaloa and Norte del Valle drug cartels; and the 2015 Swiss leaks

by the ICIJ, which according to one media outlet, revealed how HSBC's Swiss private banking subsidiary had become the "home of tax cheats".

Journalists, regulators and academics are all asking the same question : is bank secrecy being used as a value proposition strategy to deliberately enable some banks to act as conduits for IFFs that offer a lucrative client base? Speaking to the broadcaster France 24 in the aftermath of the Swiss Leaks, Serge Michel, a senior reporter for *Le Monde*, seemed to asnswer the question in the affirmative. According to Michel, "HSBC because of its aggressive objectives in client acquisition had developed clients in very dangerous areas such as arms merchants, drug dealers, and terrorism financers" (France 24 English, 2015, 01:16-34). Moreover, the abuse of bank secrecy to enable IFFs has generated ever more urgent calls for scrutiny, as world leaders have acknowledged that the negative effects of IFFs are now undermining efforts to achieve sustainable development (UNCTAD, 2020).

Sustainability at stake

As global leaders become more aware of the reality that finance is indivisible from sustainability, IFFs have been established as a bona fide hindrance to climate change mitigation efforts. Under target 16.4 of the Sustainable Development Goal (SDG) Agenda, states have committed to eliminating IFFs by 2030 (United Nations, 2015b). One reason for seeking to eliminate IFFs in relation to sustainability is the need to stop the transmission and sheltering of proceeds of environmental crime (UNCTAD, 2020). Today, environmental crime such as illegal logging, illegal mining, and illegal fishing has reached a scale where it has become an economy in its own right. It is reported that worldwide, environmental crime proceeds are between $110 bn and $281 bn per year (UNCTAD, 2020).

Beyond targeting direct environmental crime proceeds, governments are also concerned with the impact of IFF-related tax evasion on sustainable development. Increasingly, tax evasion, especially through banks in offshore financial centres (also known as secrecy jurisdictions), has become inextricably linked to reduced financing for sustainability development in poorer countries. Governments have agreed that such IFFs affect the ability of the least developed states, particularly in Africa, to raise the money needed to finance the SDG agenda (United Nations, 2015a). According to UNCTAD (2020), pulling the plug on $88.6 bn in IFFs lost annually from Africa could bridge half of the continent's SDG financing gap.

Why IFFs are an ethical problem

The problem of IFFs has brought to light an ethical deficiency within the banking industry (UNCTAD, 2020), intensifying the debate about

the greed of some of the world's biggest banks. According to Serge Michel, these banks have knowingly "accumulated this unique brand of risky clients" (France 24 English, 2015, 01:35-45).This pursuit of profit at all costs and without moral responsibility is the main ethical indictment against banks. Indeed, in his book *Capitalism's Achilles' Heel*, the former president of Global Financial Integrity, Raymond Baker, argues that IFFs in the banking industry are being caused by what in ethical terms would be called normative approval for criminality. within the industry. Baker's damning verdict is captured when he writes that:

> "Rampant illegalities regularly perpetrated by businesspeople and bankers cannot exist in an intellectual vacuum. Both must be dependent on justifications that have settled into the substructure of capitalism itself. [...] Something is saying to practitioners in the free-market system that this is okay, this is reality, this is the way the process works, this widely condoned illegality." (Baker, 2005. p.280)

Evidently, this normative approval for IFFs in some banks can be traced to the attitudes of leaders within the banking community. One example is the 2015 interview by former Credit Suisse General Director Hans Geiger with the German news outlet, DW News. When asked whether banks were responsible for some of the infractions revealed by the Swiss leaks, Geiger remarkably stated that : "It is absurd to make banks responsible for their clients' payment of their taxes. It does not work that way. It isn't ethics, it is just political nonsense" (DW News, 2015, 02:40-59).

This indifference by Geiger unfortunately represents what Peters (2021) refers to as the lack of "moral responsibility of enterprise" (para 15). Generally, we understand this to mean a non-ethical market culture that has jettisoned ethical considerations from business decisions and hence developed a normative approval for the harmful effects of business activities on society. For instance, Peters (2021) argues that it is this very lack of moral responsibility for enterprise that implicated McKinsey in the opioid crisis. According to Peters (2021), we must remember that "the Mckinsey recommendations to Purdue were directly aimed at extreme sales improvement and the analysis failed to address the potential of specific incentives to increase addictive, destructive behavior" (para 14). Sadly, it is this same attitude that can be discerned in the decision-making processes of some banking institutions.

Ethical theorists in conflict

There may be little or no divergence among ethicists regarding the view that IFFs via the abuse of bank secrecy signify a normative approval for crime in the banking industry or at least in some banks. However, there is also no convergence

when it comes to determining which ethical theory should prevail in dealing with the abuse of bank secrecy. This lack of convergence among ethical theorists is highlighted by the current public debate about the regulatory approaches being rolled out in relation to bank secrecy. Hostility in the banking community and its stakeholders towards these regulatory approaches is fuelled by a fear that they would jeopardise the future of the banker-customer relationship by dismantling a major bulwark supporting the fundamental right to privacy. By this argument, such a move would be contrary to notions of the rule of law, on which democratic societies are built.

This opposition to regulatory approaches that undermine bank secrecy indicates that for many in the banking industry, such regulatory frameworks rely on a fundamentally flawed ethical theory of utilitarianism involving selective sacrifice, which contradicts the traditional Western regard for individual rights. For instance, on 16 March 2018, the local banking community in Uganda and its stakeholders was infuriated when the Uganda Revenue Authority (URA), the country's tax collection agency, directed all Uganda's commercial banks to submit the personal account details of their resident customers for the purposes of effective tax assessment (The Independent, 2018). In a statement signed by the chairman and the executive director of the Uganda Bankers Association (UBA), the UBA noted that its members, had "reached a decision […] to file a petition in the Constitutional Court contesting the constitutionality of the various provisions of the tax law relied on by the URA in their notice" (The Independent, 2018, para 3). The Uganda Law Society also released a statement, emphasising that, "…all financial institutions and non-bank financial institutions are under a constitutional duty to ensure that no person interferes with their client's privacy" (The Independent, 2018, para 8).

Beyond Uganda, the banking industry worldwide has been faced with similar concerns. In 2009, G20 leaders decided "to end the era of bank secrecy" (OECD, 2011, p.2). True to their promise, in 2014 the OECD introduced the Common Reporting Standard through the Automatic Exchange of Information (AEoI) regime, which required banks to automatically submit the financial information of non-residents to their governments. (OECD, 2014). Opponents of the AEoI regime viewed the directive as a smoke screen for the curtailing of the civic right to privacy. In an interview for Dukascopy TV the Secretary General of the Convention of Independent Financial Advisors (CIFA), Jean-Pierre Disserens, said of the AEoI regime that, "we are basically forgetting the individual freedom of each single citizen and it is absolutely absurd to take that right which is an important civil liberty" (Dukascopy TV (EN), 2014, 02:25-38).

Should finance simply pick its poison?

Classical liberal individual rights theory is an ethical theory whose historical roots can be traced back to the 1215 Magna Carta in England, as well as the American War of Independence and the French Revolution (Tamale, 2020). In the 17th and 18th centuries, classical individual rights ethical theory was popularised by philosophers such as Thomas Hobbes, John Locke, Jean Jacques Rousseau, who argued that individual fundamental rights should be protected by the government under a social contract which regulated the relationship between the citizen and the state (Tamale, 2020). Criticism of classical liberal individual rights-based ethical theory stems from ethical theorists who rely on Jeremy Bentham's theory of utilitarianism and its emphasis on communitarian over individual interests. For instance, Tamale (2020), argues that the capitalistic nature of classical liberal individual rights theory benefits only the few who have thrived off capitalism. She writes that:

> "…the atomistic de-contextualized individual implicit in this theory excludes the communitarian interests and identities prevalent in non-western societies. […] the reality is that it serves the interests of the few who have gained dominance under the capitalist mode of production" (p.199).

Tamale's argument reflects a major characteristic of Bentham's utilitarianism: allowing the sacrifice of some individual rights for the "greater" good of society. Bentham's notion of "the greatest good for the greatest number" has also been described as an approach of "selective sacrifice" (Baker, 2005, p.302-303) which places a quantifiable value on rights and in some instances justifies the restriction of rights on the basis that the "ends justifies the means" (Baker, 2005, p.309). For many, selective sacrifice is not just a characteristic of utilitarianism, but a flaw, because it is inconsistent with the fundamental regard for individual rights that underpins modern Western democratic societies.

Yet there is no denying that communitarian concerns have become more prevalent and valid as the misuse of rights has become a common feature of commercial malfeasance, which has had a detrimental impact on communitarian interests such as sustainable development. To mitigate some of the effects of the unethical misuse of rights, regulators have taken the position that regulatory approaches, which limit fundamental rights while pursuing a legitimate objective, are necessary. Like many rights, the right to privacy can be limited without being lost. Nonetheless, opponents of current regulatory approaches against bank secrecy view these approaches as going too far. The sharp difference

in perceptions has left the banking industry in a war with itself over its values, where the industry is being invited to pick its poison.

Is this ethical dilemma avoidable ?

However, if we look closely, it is clear that the rationale for subscribing to one ethical theory over another is a perceived sense of injustice arising from the outcomes of each ethical theory. A critical analysis of both the communitarian concerns of utilitarianism and the individual rights concerns of classical individual rights theorists suggests that both intellectual camps have a common concern for justice. For utilitarians, it is the disregard among individual rights-based theorists for communitarian social justice notions; for the latter, it is the disregard of utilitarians for individual rights and rule of law-based notions of justice.

Given this shared perception of injustice, it is worth asking if the ethical dilemmas identified by these different philosophical traditions is avoidable. Could it indicate that an "either/or" approach in ethical philosophy only creates a false dichotomy and that perhaps it is time for finance to embrace the hybridization of normative ethical theories? Indeed, this is the point that Rawls (1971) makes when he writes:

> "In this case, while men may put forth excessive demands on one another, they nevertheless acknowledge a common point of view from which their claims may be adjudicated. If men's inclination to self-interest makes their vigilance against one another necessary, their public sense of justice makes their secure association together possible. Among individuals with disparate aims and purposes, a shared conception of justice establishes the bonds of civic friendship; the general desire for justice limits the pursuit of other ends" (p. 4-5).

How, therefore, should we view the sharp divide in normative ethical theories? Is it philosophical fundamentalism? A suggestion to that effect has been made by Baker, in trying to rebut the claims of those who have traditionally held tribal biases against capitalism by citing the apparent discrepancy between Adam Smith's earlier work, "*The Theory of Moral Sentiments,*" and his later work, "*The Wealth of Nations*." Baker (2005) writes:

> "Reduced to its fundamentals, the argument is that sympathy and self-interest are incompatible at best, if not wholly irreconcilable. Economic man pursuing his profits cannot also be sympathetic man acting with benevolence. Yes, we see the dichotomy in many people. But the appropriate question is, is this a necessary condition, an inevitable tension, arising from conflicting forces impinging on each of us?" (p.294)

Baker goes on to show that in fact, Adam Smith was disposed to

both moral and market sentiments in equal measure. Indeed, because the imperative need of all ethical philosophy is to address injustice, we can confidently state that philosophical fundamentalism is harmful, not helpful.

Finance as a matter of justice

We can say that armed with an ideological clarity in which the hybridisation of ethical philosophy is based on justice as a common denominator of all theories, finance can translate the moral verdict against injustice into the building of a just financial system characterised by i) just financial institutions that look beyond the narrow confines of their own shareholder needs to the broader needs of other stakeholders in society; ii) just financial regulators who proportionately balance the objectives of regulation with the harms it causes.

For regulators, decision making processes in finance must be approached with the understanding or appreciation that in democratic societies, it is generally accepted that regulation which has the effect of limiting fundamental rights must be proportionate to be legitimate. The test of proportionality is the delicate balance between protecting fundamental rights and preventing the misuse of those rights by the holders. It is important always to bear in mind that the fundamental rights are not the exception to those rights.

For institutions, decision making processes must be approached with the understanding that financial institutions have a duty of moral responsibility implicit in the social contract that underpins a democratic society. As Rawls (1971) put it, institutions must have a "criterion for discouraging desires that conflict with the principles of justice [...] so as to encourage the virtue of justice in those who take part in them" (p. 230-231). This is not merely an ideological or utopian concept. According to Baker (2005), it is "a matter of will put into practice" (p. 345); in other words, it is simply a matter of banks embracing their moral responsibility for enterprise.

Achieving hybridisation

For finance to achieve the objective of an ethical culture of justice in decision making processes, there is a need to make one final appraisal. We have already answered in the negative whether the ethical dilemma described above is avoidable. We have also identified why it is in the best interests of finance for decision making processes to be guided by justice as a common denominator. How can this be achieved? The answer must be that ethical theorists should re-examine their current approaches to teaching ethical philosophy. The current ethical dilemma should teach us that approaches to teaching ethical philosophy which leave no room for hybridisation, and which mirror pseudo-activism by pursuing indoctrination rather than

education, are to blame. According to the American philosopher Christina Hoff Sommers, academia has become increasingly intolerant of intellectual diversity. In an interview with Daily Wire's Ben Shapiro in 2016, Sommers noted that university departments have started to "hire their own," and do "not present the other side respectfully" (Ben Shapiro, 2018, 05:30-39).

Unfortunately, the tendency to treat ethical philosophy in a zero-sum manner has become common in academia. Ethical philosophy is often taught in a way that emphasises philosophical fundamentalism through a radical monomaniacal emphasis on one ethical theory, while adopting a "see no evil, hear no evil, and speak no evil" approach toward the same theory. Many ethical theorists have ignored the fact that the fragmentation of ethical theories should not affect the complementary nature of ethical philosophy; especially bearing in mind that normative ethical philosophy is based on ideology rather than quantitative empiricism.

One can view the idea that there is an unbiased point of convergence in political thought as inherently biased itself (Solnit, 2021). The same cannot be said of what one could call ethical centricism. It is consistent with general philosophical discourse to recognise that firstly, the fragmentation of normative ethical theories is simply a result of varying subjective moral interpretations of ideology (Keitch, 2018); and secondly, and that there is indeed a valid point of convergence, which is justice. (Thomas and Thomas, 1959).

To sum up, while academic activism has proved an important tool for intellectuals to dispense their duty to society (Smith and Smith, 2019), this paper advocates a non-monomaniacal approach to teaching ethical philosophy in finance. Academic activism in ethical philosophy should bear in mind that there is no substantive ethical theory that would fit all circumstances today. Consequently, the purist "one-size-fits-all" approach to rebalancing the relationship between broad human values must be substituted with a hybridised "best-fit" approach. Academic activism in ethical theory should equip students of ethical philosophy in finance with the training to select from each ethical theory elements that are essentially derived from the concept of justice and reject those that are divorced from this concept.

Conclusion

The banking industry must come to terms with the fact that while there may be many who sympathise with opponents of regulatory approaches against bank secrecy, even the most ardent classical liberal individual rights ethical theorists would be hard-pressed to continue justifying the unjustifiable if banks do not clean up their "mess". A moral responsibility for enterprise must

be embraced by banks. But equally, regulators must give due regard to the doctrinal rationale behind individual rights that form the fabric of society. In this regard, regulators should avoid what is easy. Making bad laws may be expedient to catch the "bad guys" today, but history shows that bad laws made with the best intentions can be used against good people tomorrow. The strength of western democratic civilisation depends on its ability to thwart any such opportunity for injustice to be inflicted on the individual.

The future of the banker-customer relationship rests on how the current bifurcation in ethical theories can be resolved, as do some of society's most pressing needs, such as tax justice and sustainability. This false dichotomy in ethical theories will continue to prevail at the expense of justice if ethical theorists maintain their insistence on the need for finance to pick its poison. The aim of this paper has been to demonstrate the need for the hybridisation of ethical philosophy in decision making processes within the finance industry. Ethical theorists must now guide a way towards a normative ethical approval for justice through the hybridisation of normative ethical theories, rather than perpetuate decision making processes which are based on a false dichotomy in ethical philosophy. •

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Is Offshoring Ethical?

Ethics & Trust in Finance
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Finalist

Christopher Stubbs
Ireland
Procurement Professional, Pharmaceutical Industry, Basel (Switzerland)

* The views expressed herein are those of the authors and do not necessarily reflect those of the Organization he is affiliated with or of the Jury.

In the post-Panama Papers world, there was much cause for optimism. The largest financial leak in history led to all kinds of encouraging soundbites and consensus appeared to be reached regarding what legislative steps were necessary to bring about meaningful change.

However, 2018 was a year that must have ravaged even the most ardent optimist's cheer. Notwithstanding another series of major financial scandals, including Danske Bank and 1MDB, it was also - most importantly - a year in which the capacity and willingness of monsters to lash out in the most deplorable fashion was publicly demonstrated, over and over and over again.

Eighty journalists and media workers were killed last year (RSF 2018, p.3). Among them were Ján Kuciak, a 27-year-old Slovak, who was "shot dead in his home together with his fiancée, Martina Kusnirova, on 21 February", and Victoria Marinova, a 30-year-old Bulgarian broadcaster who "had been beaten, raped and strangled" (RSF 2018, p.11). Both murders were committed in the EU. Both victims were comfortably young enough to make submissions for the Ethics and Trust in Finance Prize.

This paper will make the following series of arguments:

(i) Any discussion pertaining to ethics in finance needs to put the offshore system at its centre. Otherwise, the discussion is, in large part, a waste of time;

(ii) The legislative solutions to produce better outcomes are already known and in the

process of being implemented;

(iii) As a matter of the utmost urgency, much greater protections need to be offered to journalists and whistleblowers, who often expose the worst kinds of wrongdoing;

(iv) Incentives are key. At present, bad incentives are driving the behaviour of governments, corporate interests, media reporting and private citizens, with predictably unfortunate outcomes.

A brief commentary will conclude the paper.

The Ethics of Offshore Jurisdictions

The offshore system can be difficult to nail down. For the purposes of this paper, it refers to "jurisdictions that deliberately create legislation to ease transactions undertaken by people who are not resident in their domains, with a purpose of avoiding taxation and/or regulations, which they facilitate by providing a legally backed veil of secrecy to obscure the beneficiaries to those transactions" (Palan, Murphy & Chavagneux 2010, p.45).

Regardless of the scope of the above definition, it is appropriate to point out that there are legitimate reasons for actors to engage in such a system. For instance, an offshore jurisdiction may provide access to more developed and stable banking and legal institutions while companies may simply wish to shield expansion plans and property acquisitions from competitors. In both instances, there is a good argument to be made for using offshore facilities.

A Brief History of Leaks and the Value of Offshore Jurisdictions

There have been numerous leaks over the last few years, including: the HSBC Suisse leak (2006); the UBS and LGT leaks (2008); Julius Baer (2008); Luxleaks (2012); the British offshore tax havens leaks (2013 & 2014); the Panama Papers (2014); and the Bahamas leak (2016) (Oei & Ring 2017, pp. 11-27). More recently, the Paradise Papers has resulted in a further increase in interest in offshore systems, as the industry's size and scope becomes clearer.

The figures involved are staggering. For example, the following are indicative of the stakes:

- "The European Union alone loses out on a thousand billion euros a year due to tax fraud and tax evasion." (Obermayer & Obermaier, 2016, p.312).
- "A 2008 US Senate staff report estimates that 'offshore tax abuses' result in an annual loss to the US Treasury of $100 billion in tax revenue" (Omartian, 2016, p.1).
- There has been "a fivefold surge in tax related profit shifting in the last fifteen years alone, now costing governments $300-650 billion per year" (Shaxson, 2018, p.246).

- With respect to revenues lost to tax havens, the OECD "estimates such practices cost governments between $100 billion and $240 billion in lost revenue each year" (Trautman 2017, p.844).
- "Expert (but conservative) estimates of the amount of money parked in offshore tax avoidance schemes reach to at least 20-30 trillion dollars" (Dillon, 2016, p.56).
- Regarding the relationship between foreign aid to developing countries and financial flows from those countries to offshore jurisdictions, "for every dollar that we have been generously handing out across the top of the table, we in the West have been taking back some $10 of illicit money under the table". (Shaxson, 2011, p.27).

You get the picture. The ugly reality is that when "governments try to crack down on offshore tax secrecy, for instance, an army of (…) experts step up, targeting policy makers, denigrating the reformers, persuading offshore centres like the Caymans to write new laws to spike the reforms" (Shaxson 2018, p.179). It is thus clear that there can be a massive degree of complexity and pressure for governments to negotiate.

On ethics, Grayling (2003, p.184) warned against the use of "scholastic superfluities of intricate jargon and technical refinement of use to no one but at best a few colleagues". Following this line, it should be incumbent upon anyone with an interest in the topic to be clear. Accordingly, the system described above stinks. No amount of smart talk from well-paid advocates will change that fact.

In a rare intervention last year with respect to economic policy, The Holy See (2018, p.13) lamented that "it is not possible to ignore the fact that those *offshore* sites (…) have become usual places of recycling dirty money, which is the fruit of illicit income (thefts, frauds, corruption, criminal associations, mafia, war booties etc)." The implication is clear. The game of supranational regulatory arbitrage is offering protection to the worst kind of thugs: the kind that send men in the night to visit the most courageous of youngsters living outside Bratislava. Explicitly stated, "international mafias and weapons dealers actually depend on offshore centers, for it is through this option that they manage to launder revenues from illicit activities" (Ferreira & Madeira 2010, p.6).

In this context, I believe that offshore jurisdictions and the protections they offer (and to whom) must be the focus of any serious discussion about ethics in finance. To be clear, while corporate ethics training programmes are nice, they will not make a meaningful difference. The discussion needs to center on offshore jurisdictions.

Green Shoots

Despite my gloom, there are reasons to be hopeful. The legislative solutions for tackling offshore jurisdictions are known and a consensus appears to be forming about their effectiveness. These measures have already reaped some encouraging results. Concisely, the "first big step would be to introduce an effective system for the global exchange of information about bank accounts", with the second step being "a globally transparent register of companies", where true beneficial owners could be readily identifiable, and the provision of false information made a criminal offence, with tough sentences for breaches (Obermayer & Obermaier 2016, p.305). The devil may be in the detail but that is as complicated as it gets.

As alluded to, there have been "significant developments in coordinated global action to increase cross border transparency and information exchange" (Oei & Ring 2017, p.4). For example:

- Ioannides (2016, p.35) notes that for the EU, "the implementation of the OECD/G20's automatic exchange of information (AEOI) was adopted in December 2014".
- Oei and Ring (2017, p.21) continue that following two special committees established by the EU in 2015 (i.e. TAXE 1 and TAXE 2), the "creation of a beneficial ownership register and a proposed framework for whistleblower(s)" was recommended.
- "In October 2015, the OECD's Base Erosion and Profit Sharing (BEPS) project published its final report, requiring companies to divulge where they earn their profits, carry out operations and pay tax" (Ioannides 2016, p.51).
- Further, the "G5 countries have agreed (…) to develop a global multinational multilateral system for an automatic exchange of beneficial ownership information" and "in 2016 the EC adopted a proposal for full public access to beneficial ownership registries for certain legal entities" (Oei & Ring 2017, p.25).
- The EU also adopted the Anti-Avoidance Directive in 2016 (Dillon 2016, p.23).

Jallow (2016, p.11) cites US legislative efforts such as FATCA (Foreign Account Tax Compliance Act), passed in 2010, which "primarily aims to prevent tax evasion by US taxpayers by using non-US financial institutions and offshore investment instruments". The same author proceeds to make twelve broad recommendations, including: enhanced powers for tax authorities to gain access to bank data; establishment of an anti-global tax avoidance and evasion commission; coordinated

information sharing between tax administrations and central banks; and an institutionalised whistleblowing system, with laws that protect the identities of whistleblowers (pp. 13-14).

What are the results of this increased urgency? Are the efforts paying dividends? By any measure, the answer is a resounding yes. The OECD (2018, p.39) reports that, as of July 2017, "in response to disclosure initiatives and similar measures put in place prior to start of exchanges, approximately 500,000 individuals have already disclosed offshore assets worldwide, and some EUR 93 billion in additional tax revenue has been collected". This equates to a massive investment fund for hospitals, schools, police forces, homeless shelters, drug rehabilitation programmes and other public spending projects which cash-strapped governments would otherwise have not been able to afford.

The figure includes the following publicly-reported tax revenues that were recovered (OECD 2018, pp. 40-41):

Brazil – approximately EUR 12 billion;

France - EUR 7.8 billion;

India - EUR 6 billion;

Indonesia - more than USD 10 billion;

Mexico – approximately EUR 826 million;

Burkina Faso – USD 2.4 million (from the first seven information requests).

In this context, even the most entrenched pessimist must admit that things are moving in the right direction.

Results on both sides of the Atlantic

Furthermore, Trautman (2017, pp. 851-855) reports that the US Department of Justice (DOJ) brought approximately 60 cases against individuals and more than 60 against corporations between 2009 and 2017, using the FATCA and other laws. This litigation led to the collection of more than $4 billion in penalties. In the same period, the Securities and Exchange Commission (SEC) initiated proceedings against more than 85 companies and around 35 individuals, resulting in the collection of around $2.5 billion. Lastly, the DOJ has helped recover hundreds of millions of dollars for the people of nations such as Nigeria, Kazakhstan, South Korea, Peru and Nicaragua, using the Kleptocracy Asset Recovery Initiative (2010).

This is just the beginning. The OECD reports that The Global Forum on Transparency and Exchange of Information for Tax Purposes ("The Global Forum"), increased its membership to 154 in 2018, with nine new jurisdictions joining last year, while "nearly 90 governments have begun automatically exchanging information on financial accounts of non-residents" (OECD

2018, p.4), partly motivated by the successes of the early adopters. It is also noteworthy that, in line with the policy prescriptions cited earlier, "at the request of the G20, the Global Forum and the Financial Action Task Force (FATF) work together on the ways to improve the availability of beneficial ownership information and its international exchange" (OECD 2018, p.11).

The agenda for 2019 represents a heavy workload. It envisages the delivery of existing AEOI commitments; assessments of legal frameworks; expansion of support for developing countries; the publication of 30 reports; and an intensification of technical assistance, with a view to "a strong priority being placed on the availability of, and access to, beneficial ownership information" (OECD 2018, p.43). A cynical analysis of these developments might conclude that these are just more examples of bureaucracy. However, once this system of coordination matures, it may well have the capacity to hold the nefarious to account when future scandals occur, by depriving them access to the shadows in which they hide.

The Assassin's Veto: Terrifying Developments for A Free Press

"'There are crooks everywhere you look now', Daphne Galizia wrote. 'The situation is desperate.' Those were the last words she ever published. The 53-year-old journalist was killed when her car exploded later that day" (CPJ 2018, p.12). That particular horror unfolded in a European capital on a dark day in October 2017.

Holding power to account is a dangerous business. Earlier, I cited a figure of 80 journalists killed in 2018, of whom 49 were deliberately targeted (RSF 2018, p.6). Regrettably, that does not reveal the full extent of the danger. Consider, for example, that in 2018 348 journalists were detained, 60 were held hostage, while a further three went missing (RSF 2018, p.3). It was a year "in which journalists are accused of terrorism on the basis of a single word or a single phone contact" (RSF 2018, p.15).

The figures for mortality and impunity rates during the past decade make for even grimmer reading. In a UNESCO-cited report, the IMS (International Media Support) notes that 827 journalists were killed in the last ten years. Frighteningly, with "only 8% of cases reported as resolved (63 out of 827), impunity for these crimes is alarmingly high. This impedes the free flow of information that is so vital for sustainable development, peace- building, and social welfare of humankind. This widespread impunity fuels and perpetuates a cycle of violence that silences media and stifles public debate" (IMS 2017, p.18).

Put yourself in a journalist's shoes. Is taking on serious topics and seeking to hold power to

account wise, given this reality? Do these horrors not serve as a *de-facto* warning amounting to a borderline veto on serious investigative reporting? Should we be surprised that, as consumers of news, we routinely find headlines such as; “Curious cockatoo inspects traffic camera” (Sky News), and “The Korean island in love with sex” (BBC)?

These headlines appeared on the homepages of the major news outlets at the date of writing (28 March 2019). It is not to diminish the importance of cockatoos or sex, but these are hardly topics that will make thugs think twice. With respect to the impunity documented above, I find it difficult to blame the journalists or editorial teams for pursuing such “human-interest” stories. If civil society is apathetic about the need to have a serious conversation about protections for journalists, then the adage “garbage in, garbage out” may apply.

A Space for Supranational Governance Organisations to Demonstrate Competence

The only good news is that there is acknowledgement of the problem at the supranational level. The UN Plan of Action on the Safety of Journalists and the Issue of Impunity, adopted in 2012, is one such example (IMS 2017, p.11). It “outlines more than 120 measures to improve safety and combat impunity through the coordinated responses of states, NGOs, media, and international organisations” (IMS 2017, p.20). Further, “five resolutions have been adopted across the UN system since 2012, including by the UN General Assembly, the UN Security Council and the UN Human Rights Council” (IMS 2017, p.57).

IMS has also proposed a framework based on its experiences (IMS 2017, pp.37-45) which merits consideration. However, traction on the issue is clearly difficult to achieve. It is still the case that in “only a small number of countries do journalists have access to state-supported programmes for protection, and even in these countries, many journalists at risk fall through the cracks” (IMS 2017, p.19).

Whistleblowers are facing difficulties of a different nature. Oei and Ring (2017) report the experiences of some of those who were behind the variety of leaks reported earlier, regarding offshore jurisdictions. For example:

- For his part in the HSBC Suisse Leak (2006), Hervé Falciani “was tried *in absentia* in Switzerland and convicted of aggravated industrial espionage in November 2015. (…) He faces a five-year prison term if he ever returns to Switzerland” (Oei & Ring 2017, p.15).
- With respect to the UBS leaks (2008), Bradley Birkenfeld was “charged by federal prosecutors on one count of conspiracy to defraud the U.S., to which he pled guilty and was sentenced

to 40 months in prison (...) subsequently awarded a $104 million whistleblower award." (Oei & Ring 2017, p.12).

- For the Luxleaks (2012), prosecutions were brought against the whistleblower (Antoine Deltour) and the journalist who broke the story (Edouard Perrin). They were charged with "theft, breach of confidentiality, trade secrets violation, and fraudulent access to automated data processing systems", and "theft, complicity in theft, whitewashing, and accessing protected databases" (Oei & Ring 2017, p.22). They were fined and received suspended sentences.

Who would dare blow the whistle, regardless of the transgressions, in the face of almost certain prosecution by the state? It is clear that whistleblowers are being aggressively disincentivised. It is in this context that "John Doe" (the source behind the Panama Papers) writes: "Legitimate whistle-blowers who expose unquestionable wrong-doing, whether insiders or outsiders, deserve immunity from government retribution, full stop" (Obermayer & Obermaier 2016, p.347). This argument is hard to dismiss, given the clear risks to whistleblowers' reputations, job prospects and liberty.

The Indispensability of Democratic Mandate

The above, however, needs to be qualified. In a New Statesman debate (2011), Julian Assange appeared on the same stage as the British author Douglas Murray. Mr. Murray put a series of questions to Assange that are similarly difficult to dismiss. Among other questions, Murray asked: "Who funds Wikileaks?"; "Who works for you?"; "Who are you involved with?" "Where are you even based?" Importantly, Murray also asked: "What gives you the right to decide what should be known to the public and what should not? Governments are elected, you, Mr. Assange, are not."

Oei and Ring (2017, p.44) also cite challenges in this respect, stating that "leakers have obvious discretion over whose information to collect, when to collect, what kinds of information to collect, and what date ranges to capture". Referring to the organisations that ultimately disseminate the leaks, the authors note that they "may have independent and potentially conflicting agendas that may shift over time and that may not be primarily about optimizing tax compliance, enforcement or social welfare" (Oei & Ring 2017, p.46).

The need to provide whistleblowers with protections, whilst acknowledging the absence of a democratic mandate for whistleblowing organisations thus needs to be balanced. Can this goal be achieved? I would suggest that auto-immunity for leaks made through public channels, such as

EULeaks, launched in 2016, could help close the gap in this respect. It seems reasonable that if individuals are incurring enormous personal risks to protect what they believe to be in the public interest, then public institutions should seek to protect them in return. Of course, pitfalls exist. For example, it could well be that the leaker gets quashed if submissions are made on a national level, where the subject of the leak has both power and an interest in suppressing the information. It seems to me that such a system could only function at the supranational level. Even then, consensus around the idea and how this system would work in practice would clearly be difficult to achieve.

However, it is noteworthy that in March 2019 the European Parliament "reached a provisional agreement on the first EU-wide rules on protecting whistle-blowers when they report on breaches of EU law" (EU Parliament 2019). Key aspects of the proposed legislation include ensuring safe reporting channels and safeguards against reprisals. This is certainly a commendable step in the right direction.

Incentives

In *The Power of the Powerless* (1978, p.9), Havel wrote of Soviet era communism that "individuals confirm the system, fulfil the system, make the system, are the system." Havel's words still hold a compelling logic with regard to the two major topics addressed in this paper: – the system of offshore jurisdictions and threats to journalists and whistleblowers.. There is no conspiracy. There are just individuals acting in line with the prevailing structure of incentives. Against this background, this section will highlight a series of heuristic approaches for different players which merit consideration.

1. **Government**

The present situation: Governments that maintain an offshore economic model do so to attract foreign investment and jobs to their local jurisdictions. Any narrative that challenges the merits of such an approach is zealously defended against on the grounds of *tax competition* or *tax sovereignty,* etc.

Heuristic approaches:

(i) <u>Political Isolation:</u> In *Why Nations Fail* (Acemoglu & Robinson 2012, p.74-75), the authors cite the importance of inclusive economic institutions as critical to a nation's success, with characteristics including "secure private property, an unbiased system of law, and a provision of public services that provides a level playing field in which people can exchange and contract…". This point is made with respect to individual nations. However, a double standard is present if economic institutions are inclusive in nature at a national level, but extractive by nature when orientated towards external players. The authors continue: "The most common reason why nations

fail today is because they have extractive institutions" (Acemoglu & Robinson 2012, pp.368-369). How the inclusive versus extractive nature of institutions works between countries is thus of critical importance.

Palan *et al*. (2010, p.238) note that "tax havens raise important questions about the sovereign rights of smaller countries; they also raise questions about the nature of sovereignty more broadly; especially where the rights of one state impinge, or are perceived to impinge, on the sovereign rights of other states".

Questions of sovereignty are thus on the table, although perhaps not in the manner originally conceived, if a country is actively contributing to the failure of other nations via the extractive orientation of her institutions, in the context of targeting foreign-based citizens and businesses. Reputational risk, financial risk, willingness of other nations to make new agreements and to honour existing ones (on bilateral and multilateral levels) may all come into play. The risk of political isolation and diminished standing in the international order should not be underestimated.

(ii) A Two-Way Street: It follows that if government *abc* seeks to frame its offshore economic model as a matter of tax sovereignty, then the same logic holds if government *xyz* starts targeting businesses in the jurisdiction of *abc*. The principle is also applicable if everyday citizens who dutifully pay their taxes in a given jurisdiction notice that there are multinational corporations paying nothing to state coffers. By persisting with this demonstrable unfairness, governments are incentivising their own tax-paying citizens to explore tax avoidance schemes.

(iii) Massive tax takes foregone: In terms of reputation protection and seeking to be perceived as a reliable partner in commitment to offshore, governments run the risk of foregoing enormous tax takes. In the case of Ireland, for example, in September 2018 there was still EUR 14.3 billion sitting in an escrow account, paid in by Apple following an EU ruling that state aid had been provided *vis-à-vis* a favourable tax regime (The Guardian, 2018). The matter is still progressing through an appeals process.

Furthermore, disincentivising whistleblowers in the manner discussed reduces the likelihood of being able to tap into enormous reserves of untaxed wealth.

Competing Incentives in the Private Sphere

2. **Corporate Executives**

The present situation: Corporate executives are incentivised to pursue offshore tax reduction strategies because their firms might be left at a competitive disadvantage if they do not. In addition, their fiduciary duty may compel them legally to pursue such strategies.

Heuristic approaches:

(i) Share price and reputation effects: Consider that the Panama Papers data leak "erased US$135 billion in market capitalization among 397 firms with direct exposure to the revelations (…), reflecting 0.7 percent of their market value" (O'Donovan, Wagner & Zeume 2017, p.26). That is $340 million on average. The leak "wiped a total of 220-230 billion dollars of market capitalizations of firms around the world" (Wagner, 2016). Interestingly, "high reputation firms are significantly more negatively affected when implicated" (O'Donovan et al. 2017, p.5). In the context of continuing leaks, it is thus a significant risk for corporate executives to continue pursuing offshore strategies.

(ii) Compliance costs: Compliance costs can be enormous in a changing regulatory landscape. When the US initiated FATCA, for example, "UK business face(d) one-time implementation costs of £2-3 billion to comply with its provisions, followed by ongoing costs of £100-170 million annually" (Omartian 2016, p.6). It stands to reason that if firms are not engaged in the offshore game, then substantial compliance costs can be eradicated, if not greatly reduced. It is in this context that "regulators need to focus on 'nudging' – encouraging, persuading and empowering – companies to recognise and embrace the commercial and other strategic benefits of more open communication" (Fenwick & Vermeulen 2016, p.7).

(iii) Political willingness to leverage massive fines: The ICIJ reports that the "global tally of fines and back taxes resulting from the Panama Papers investigation's exposure" now exceeds $1.2 billion" (ICIJ, 2019). Furthermore, the same publication notes that this figure "almost certainly understates total revenue raised as a result of the Panama Papers given that many countries do not disclose information on tax settlements".

(iv) Inverted Fiduciary Duty: McGee (2016, p.8) notes that "corporate board members have a fiduciary duty to their shareholders to safeguard the assets of the corporation. (…) Thus, the argument could be made that the top management of a corporation has a fiduciary duty to export profits if doing so is in the best interests of the shareholders."

The calculus could be changing with respect to the implications of fiduciary duty, given the impact on the share prices of companies caught up in leaks, compliance costs, and the demonstrated willingness of governments to leverage heavy fines. For instance, there could be a legal basis for shareholders to argue that the executives acted in contravention of their fiduciary duty, if taxes saved via offshore jurisdictions are exceeded by compliance costs, share price hits and fines (in the instance of a disclosure).

Does Violence Need to be Inevitable?

3. Media Organisations

The present situation: It has become truly dangerous for media outlets, journalists and whistleblowers to hold power to account. Hence, a shying away from difficult topics may be emerging.

Heuristic approaches:

(i) Coordinated disincentivising of monsters: Considering the dangers and examples of impunity highlighted earlier, I find it impossible to blame media organisations that are reluctant to take on hard-hitting stories. The solutions might come from "concerted efforts through national coalitions and partnerships or under state-led mechanisms (that) can build a safer climate in which the media can work" (IMS 2017, p.49).

Yet the most effective tool for better outcomes may be the global media platforms themselves. Whenever a journalist is murdered, coordinated news coverage across networks may just serve as a strong disincentive. The reporting would ideally follow the work of the deceased, and provide in-depth analysis of the business holdings and individuals the journalist was investigating. However, this would necessarily require broad participation, because a small number of players sticking their heads above the parapet would be extremely dangerous for them to do so.

4. Private Citizens

The present situation: High levels of apathy exist with respect to the integrity of politics and business, reinforced by repeated scandals and seemingly impenetrable opacity.

Heuristic approaches:

(i) Democracy as a vehicle for accountability: Apathy is understandable in the face of the opacity that characterizes offshore jurisdictions. However, these matters do not simply concern finance and economics, but also speak to the vitality of democracies, considering that "opaque jurisdictions contribute to the creation of an extreme concentration of wealth, which may cause economic instability and long recessions" (Ferreira & Madeira 2010, p10). A good case can be made for individuals to be a little less apathetic. "People who often feel hopeless about prospects for change often forget that democracy is a mighty weapon, and it remains very much alive" (Shaxson 2018, p.273).

Conclusion

This paper set out to make four arguments and the success with which each has been made is for others to decide. I believe there is a clear relationship between the two main topics of offshore jurisdictions and protections for journalists and whistleblowers. Opacity kills by endangering those who seek to reduce it. When tackling it in public policy forums, this should perhaps be borne in mind, as it

packs more of an emotional punch than purely numerical and statistics-based arguments. I hope that (a) something akin to a Treaty of Westphalia can be negotiated with respect to tax avoidance and evasion; and (b) the free press, as most people understand it, is upheld, supported and protected by all available means.

Lastly, the following comments seem particularly pertinent regarding each of the topics addressed. On offshore jurisdictions, the former US Attorney General Loretta E. Lynch remarked that "acquiescence is the very opposite of good government – hoping for right to come from what is profoundly wrong – inserts a cancer into the ethical life of a society" (Trautman 2017, p.840). If such sentiments are reflected in public policy moving forward, then the future can be very bright indeed.

Although protections for journalists and whistleblowers are not a laughing matter, an old Soviet joke neatly captures the absurdity of the situation:

"A big crowd of people is quietly standing in a lake of sewage coming up to their chins. Suddenly a dissident falls in it and starts shouting and waving his hands in disgust: 'Yuk! I cannot stand this! How can you people accept these horrible conditions?!' To which the people reply with a quiet indignation: 'Shut up! You are making waves!'" (Yurchak 2005, p.278).

I hope you agree that if we find ourselves standing around in sewage up to our chins and one of us happens to fall, directing our anger at that particular person will not help change anything in the long run. •

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Part V

Ethics in Culture and Behavior

How to Shape Moral Attitudes in Banking - the Polish example

Ethics & Trust in Finance
Global edition 2018-2019

Second Prize

Dr Mateusz Kucz
Poland
Assistant professor,
Maria Grzegorzewska University,*
Warsaw (Poland)

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

This paper concerns the practical problem of the evolution of moral attitudes among representatives of Poland's banking sector in the face of the requirements imposed by the Sectoral Qualifications Framework for Banking in Poland (SQFB). In order to answer the question addressed in the title, we should reflect on whether work in the financial sector has a moral aspect. I will tackle this problem in the opening chapter of the paper.

In the second part, various methods and tools will be highlighted that are currently used to influence moral attitudes in professional practice. After demonstrating some downsides of such tools, part three will explore possible solutions to some emerging issues and identify relevant tools to meet the requirements established by the SQFB.

In the same section I will discuss an approach to shaping moral attitudes based on Aristotle's ethics of virtue. In the classical sense, virtue ethics is often juxtaposed with calculating and selfish economic motivation. I will try to demonstrate that it does not have to be the case and that, when some criteria are met, Aristotle's concept can be aligned with market activities. In particular, his concept of *phronesis* (practical wisdom) can significantly improve and complement some existing mechanisms and help nurture moral attitudes in the financial sector.

Moral aspects of work in the banking sector

Before identifying the moral aspects of work in the banking sector, we should define what is meant by morality. Morality can be considered

as a set of social facts. If so, the technical dimensions become critical in professional ethics. The primary challenge is to find the answer to the question of what methods and techniques should be employed for effective, secondary socialisation of a specific professional role.

In this paper, however, I will rely on another understanding of morality as a person-to-person rrelationship based on taking responsibility for others. In my opinion, given the discussed context, every socially useful work somehow involves a relationship of responsibility for another person; by extension, it has a certain moral aspect. This aspect is obvious in the case of a physician or a lawyer. Less conspicuously, the moral aspect of a paver's work includes taking care that people will not trip and fall on the pavement; while for a baker it involves taking care of food quality. In such a moral context defined in this way, it becomes clear that banking sector work also has a certain moral dimension

Academic economists are increasingly aware of the moral aspects of work in banking and finance. There is growing research interest in matters surpassing the neoclassical paradigm in economics. There are publications appearing on the philosophy of economics and meta-economy or the ethics of economics which challenge the division of the subject into a science free of any axiological elements and normative economics defining goals for the former. The growing number of members of the Polish Network of Philosophy of Economics also testifies to mounting interest in the subject. Recently, a Department of Meta-economics has been established as a new unit of the Institute for Market, Consumption and Business Cycles Research at Poland's National Research Institute.

Furthermore, there are numerous attempts to provide practical answers to the ethical challenges arising in the financial and banking sector. Some of the key projects in the banking sector have been the drawing up of the Code of Best Banking Practice in 1995, known since 2013 as the Code of Banking Ethics (CBE) and the appointment of the Banking Ethics Committee in the same year. Importantly, references to the CBE can be found in the SQFB, a constituent and detailed component of the Polish Qualifications Framework. In a concise manner, the SQFB defines "qualification (by industry) necessary for 67 job positions related to: customer service and consulting, retail, SME sector, corporations, risk (credit and other, as well as risk controlling and efficiency), dealing operations, internal audit, compliance, security (including IT), marketing, and macroeconomics." (Żurawski , Panowicz, Danowska-Florczyk & Kochańska, 2017).At a basic level regarding knowledge, the SQFB requires familiarity with the banking codes of best practice and ethics (Żurawski et al., 2017, 41).

The SQFB's guidelines on social responsibility for higher qualification levels are also important in the context of the development of ethical attitudes in Poland's banking sector. Level 4 is worded as follows: "Assumes responsibility for satisfying the needs of external and internal customers in accordance with applicable regulations, supervisory regulations, internal procedures, quality standards and professional ethics" (Żurawski et al., 2017, 42).

Responsibility aligned with professional ethics is vital to the context of this work. Level 5 requires an even higher ethical standard, where an employee at this level should be a role model of ethical behaviour in his or her team (Żurawski et al., 2017, p.43). Level 6 requires an employee to be able to resolve complex ethical dilemmas in his or her professional practice (Żurawski et al., 2017, p.44). At the highest Level 7, a banking sector employee additionally promotes attitudes based on the professional ethos by developing a culture of communication and cooperation focused on solutions that generate an added value for all partners (Żurawski et al., 2017, p.45).

In conclusion, the level of moral awareness required of financial sector employees, especially in banking, is relatively high. This theme is explored both in academic discussions and by practitioners, including members of the Polish Bank Association (PBA). A noteworthy outcome of this interest is the requirements regarding employees' moral attitudes which are embedded in the SQFB. Such a programme suggests a fair degree of moral maturity across the sector.

At the same time, the proposed programme is very ambitious and demanding. I discuss below the currently available methods and tools for shaping moral attitudes in the banking sector in relation to the requirements included in the SQFB.

Classical ways of moulding ethical attitudes in professional practice

When there is a need for shaping moral attitudes due to a growing number of new ethical challenges, or a certain moral crisis erupts in a specific sphere of public life or a specific profession, we reach for two standard tools: regulations and incentives. The classic example was the response to the 2008 financial crisis. An overwhelming majority of commentators demanded increased regulation or enhanced systems of financial incentives in the financial sector.

The first way to response to the emergence of a moral crisis is to attempt to regulate the condemnable action. In such cases, a standard approach would be to develop a code of ethics. As Magdalena Środa pointed out in her article in "*Etyka*":

"The very need to frame codes is cyclical. It emerges in those professions and institutions of public life which face a crisis; it emerges where there is "insufficient" ordinary

honesty and personal uprightness. … The weaker individual decency, the more demands for codes" (Środa, 1994, p.168).

That low opinion of human behaviour seems to be well-founded if we look at numerous professional codes formulated in Poland since the 1990s. Most of them enumerate constraints and prohibitions to be observed by the representatives of various professions. These bans have an evident cyclical character and often address various specific, unacceptable behaviours.

This state of affairs rests on two popular, yet false assumptions. Firstly, many people naively and almost magically cherish a belief in ethical intellectualism. They assume that the mere identification and naming of morally reprehensible attitudes and behaviours will make people act well. However, the mere naming of moral evil is only the first step towards shaping what a moral action can be. Since Ovid's confession, *Video meliora, proboque, deteriora sequor* (I see and approve of the better, but I follow the worse), (Ovid, 7.20-21) it has been a commonly shared belief that to take a morally acceptable action we need something more than an awareness of our moral duty.

Secondly, people would like to receive a clear, unambiguous and conclusive instruction on how to act morally. Maria Ossowska gives a name to that need, "a hunger for the absolute" (Ossowska, 2000, p. 17-24). If I have a right, rules of procedure or code, I can consider it conclusive in resolving what is morally right. In this situation, I do not need to ponder "what I should do" but just check "what the code requires." In other words, this kind of instruction helps to liberate me from the constant need to take responsibility when facing moral challenges and allows me to rely on a code to discover what is moral.

In order to grasp the problem fully, it should be noted that the moral dimension of our actions consists of several elements. In the cognitive order, the first one is awareness of the moral nature of our performance. The second element is a sense of agitation (empathy, sadness, fear, a prick of conscience) which calls for action. The final element is the decision to act, following the perceived moral challenge.

In this context, let us consider the incentives for moral conduct. As with the drafting of codes, the mechanism of incentives partly allows us to evade the question of responsibility. This is because it is another decision-maker who determines what actions are desirable and what incentives should be proposed for employees. In this situation, all pressure is put on the second and third components of moral conduct. The main question is how to persuade people to act as we believe they should. The fundamental problem, however, is that external stimuli very often replace moral motivation and start to drive our choices.

Why are ethical codes not an effective tool in cultivating moral attitudes?

Leszek Kołakowski dispels all illusions regarding the effectiveness of codes of ethics in his classic essay, *Etyka bez kodeksu* [Ethics without a Moral Code]. Kołakowski points to three key flaws of "codex-ridden thinking" which are inherent to the idea of codification of ethical principles. The first problem is the asymmetry of duties and claims; the second one comes down to the heterogeneity of values.

The asymmetry of duties and claims results from the tension between the duties that we assume and a claim of the right to demand from others, so that everyone in a similar situation would recognise the same duty. Kołakowski notes that the difference between the legal and moral standards is that the former are binding universally while the latter only in particular cases. He also observes that the most morally valuable deeds are those that we cannot demand of all as an absolute duty. Moral heroism is based on the unique nature of action taken and not on acting in line with a universal obligation.

The last element stressed by Kołakowski when defending the asymmetry of duties and claims is the "*cogito* factor." It assumes that not all moral decisions translate into a universal duty. My decision, for example, regarding the choice between mine and someone else's interests, cannot in a specific situation only refer to the assessment that a third party has the right to accept the transfer [of this assessment]. The formula expressed in the third person ends in a contradiction (Kołakowski, 2010). Every code will be flawed because it is not the result of a wrong formulation of some principle but of an existing attribute of every attempt to create an ultimate moral instruction. As Barbara Skarga points out:

"Morality has never been framed into legal regulations; and when some attempted to squeeze it into regulations or systems of do's and don'ts, it became a source of repression and wickedness and only fuelled social hypocrisy. Moral problems blow legal clauses apart; they are rarely unambiguous and most often arise from the clash of opposing values whose hierarchy is anything but evident. The ethical dimension of action is lost and deformed as soon as it is subjected to codification or captured in systems of binding norms whether by the state, churches or professional groups" (Skarga, 1994, p.170-171).

With reference to this objection, the SQFB's recommendations about the need to take responsibility in accordance with professional ethics appear to be a more difficult challenge than we might expect. It turns out that it is not enough to refer to a line in the code to identify your professional responsibility because in many practical situations these provisions

will not offer unambiguous guidance on the preferred action.

In the sale of goods or services, the seller wants to dispose of the maximum number at the highest possible price. The buyer has the opposite purpose: to purchase only as much as he or she needs at the lowest possible price. A bank employee offering a product faces a dilemma: show the customer all possible options and products that might interest the customer or only selected products that are the most profitable for the bank (Lipiński, 2008, p. 92). Furthermore, in such a situation, the code may even offer contradictory guidance. Seen in this light, the code can only indicate which moral obligation should be followed immediately and not as a source of solutions to professional ethics dilemmas. We thus end up not knowing how we should understand "compliance with professional ethics", due to the lack of criteria,

Another problem raised by Kołakowski is the heterogeneous character of values. In his opinion, every code author must accept that all values which are presented as the subject of moral duty can be sequenced on the same scale, like a thermometer (Kołakowski, 2010, p.166). Since we assume the possibility of making a code, we must be ready to resolve a conflict between different values. Given this *cogito* factor, it is not possible to create a universal rule that determines which value should prevail over another in a certain situation.

In this context, however, it is important to note Kołakowski's conclusion that each moral choice is at the same time a resignation. This awareness is needed both to accumulate energy to mitigate the negative effects of choice and in order not to lose the perspective of a different choice in similar future situations. In addition, such awareness is needed, to tolerate someone else's choices which are not aligned with ours (Kołakowski, 2010, p.169). We might otherwise conclude that codes instruct us about how to become ideal. Worse, acting according to a code can delude ourselves that we are already ideal.

This threat is explicit, especially in the context of Level 5 of the SQFB, which requires employees at this level to be moral models for their team. There is nothing worse than self-styled moral heroes who consider themselves superior only because they blindly follow some externally imposed set of moral rules. Such people tend to force others to imitate their behaviour, miss the nuances and complexity of moral problems, and inflate other people's mistakes while ignoring or downplaying their own.

You cannot force anyone to recognise a person as a model or authority. On the contrary, you have to earn the right to be regarded as an authentic moral model, by demonstrating competence in resolving tough moral dilemmas. In my opinion, the requirement to be

a moral model should follow the fulfilment of those requirements by employees and not be defined as a precondition of moral development. Otherwise, we risk promoting the attitudes of self-proclaimed (and therefore false) models. If we constantly patronise people about what is right, without respecting their opinion, they will lose interest in seeking their own answers to moral questions. As a consequence, they will lose interest in morality at all and will focus on obeying commands or changing jobs.

Anyone wishing to develop and deepen their moral stance should bear this important point in mind, especially when they aim to master the ability to solve complicated ethical dilemmas effectively.

Demoralising aspects of incentives

If codes pose so many obstacles, perhaps incentives are a better tool for shaping moral attitudes? If people want to do the right thing, and we additionally reward them for such an attitude, it naturally follows that they will be even more eager to copy that kind of behaviour.

It seems quite obvious that if we have two reasons to do something, the probability that we will do it is even greater. Yet sometimes, two reasons to do something compete with each other instead of creating a synergy effect. This is important when dealing with financial incentives and morality, as has been substantiated by research in social psychology over the past 50 years. Several pivotal studies confirm the thesis that the "commercialisation" of actions causes changes to how we perceive them.

The first such study is Richard M. Titmuss's classic analysis of a blood donation experiment in his 1970 book, *The Gift Relationship*. Titmuss compared the British blood collection system, where all the blood came from volunteer donors, with the U.S. system in which some blood came from volunteers and some was purchased by commercial blood banks. Titmuss found that the British system worked better than its American counterpart at all levels and in all dimensions. The quality of blood was higher, there was less blood deficiency, less blood was wasted, the risk of contamination was reduced, and the process of collection was more cost-effective. The researcher concluded that financial incentive weakened the sense of civic duty (Titmuss, 1997).

Another noteworthy study was carried out by two economists, Bruno S. Frey and Felix Oberholzer-Gee. In 1993 the Swiss village of Wolfenschiessen was selected as a potential storage location for nuclear waste. The local citizens were invited to a referendum to decide whether such a facility should be created in their community. Shortly before the voting, the two researchers conducted a survey among the locals. They asked 305 people (out of 2,000 inhabitants)

whether they would have approved of the construction in their village of a radioactive waste storage site with low and medium levels of radioactivity. To their surprise, 51% of the respondents said "yes."

The villagers were aware of the hazard and the diminishing value of their property but were still positive because Wolfenschiessen had been selected by the Swiss parliament as the best destination for such a facility. The respondents also felt that it was their civil duty to take responsibility for the waste. Later, the researchers asked the respondents whether they would have been ready to accept the proposal of building a radioactive waste repository with low and medium levels of radioactivity in their village if the parliament had paid them compensation of CHF 5,000 per person per year. On this question, the level of acceptance dropped to 25%.

The researchers achieved similar results in subsequent studies in six other places that were considered as locations for another waste storage site. They concluded:

"Our theoretical and empirical knowledge has evolved considerably since Titmuss' intuitive theory that monetary compensation destroys altruistic values. We can now rely on an established theory of motivation crowding-out which goes far beyond the example of blood donation. This theory is consistent with a rational choice [and] therefore can be incorporated in economics. The crowding-out effect explains why the support for the toxic artefact decreased when monetary compensation was offered for its consumption (Frey & Oberholzer-Gee,1997, p. 753)."

The studies discussed above show that the shaping of moral attitudes based on an incentive scheme can often prove counterproductive. The problem is that when an incentive occurs it begins to determine choice. People stop asking, "What is my duty?", and stick to answering the question, "What is in my best interests?" One example is when executives ignore the long-term condition of their enterprises and pursue short-term profit, combined with extra financial bonuses. An over-reliance on incentives will demoralise employees in two ways. First, it causes incentivised people to lose morale, understood as a moral and inner motivation to do work. Second, professional activities lose their morality when replaced by stimuli derived from an incentive system, such as financial bonuses.

Virtue ethics as a tool for shaping moral attitudes in the Polish banking sector

It is advisable to look at virtue ethics in order to find tools that will help meet the requirements imposed by the SQFB on banking sector employees and, at the same time, avoid issues resulting from the limitations of codes and incentive-based schemes. Such attempts have already been made by contemporary

philosophers of economics. Deirdre McCloskey has written about the seven virtues of middle class economic life: love (kindness and friendship), faith (honesty), hope (entrepreneurship), courage (endurance and perseverance), temperance (moderation and humility), prudence (know-how and foresight) and justice (social balance and integrity) (McCloskey, 2006.). Similarly, Luigino Bruni and Robert Sugden have suggested that participation in work and trade is consistent with such virtues as self-help, entrepreneurship and vigilance, trust and credibility, respect for the desires of other people and the perception of others as potential partners in mutually rewarding transactions (Bruni & Sugden, 2013, p. 141–164).

Importantly, Sugden and Bruni attempt to address objections raised against economics by virtue ethics theoreticians. In their opinion, the criticism of Alasdair MacIntyre and Elizabeth Anderson is misguided because it ignores the possibility of the existence of an economics-specific *telos* or ultimate aim. The critics assume in advance that economics must always be driven by the instrumental logic of the market. From this perspective, it is not possible to practise virtues through economic activities (Bruni & Sugden, 2013, p. 144–148).

In response, Bruni and Sugden formulate a market-specific *telos* as the facilitation of voluntary, mutually beneficial transactions (Bruni & Sugden, 2013, p.153). At this point, I would note that the use of the word "transaction" may be too narrow and limit the moral elements that might be incorporated into the spectrum of economic activities. I would rather refer to it as the facilitation of voluntary and mutually beneficial exchange. Such a wording would allow the inclusion of cooperation (Sennet, 2012) as one of the possible elements of the *telos* of economics.

Barry Schwartz and Kenneth Sharpe also write about virtue ethics in banking in *Practical Wisdom* (2010). They point out that making money is not the bank's only pursuit. Banks can play a socially useful function, for example, by supporting individuals in raising capital to grow their businesses while making money out of the loan. Bearing that in mind, banks can be said to generate profit but also to develop the community. According to Schwartz and Sharp, a good banker is a trustworthy person who serves a community, takes responsibility for customers and is interested in them. At the core of this concept of banking is the relationship between the banker and the customer, which is based on mutual trust and responsibility. In Schwartz and Sharpe's opinion, a banking system without trust is very vulnerable to collapse. And trust, in the authors' view, is mainly based on practical wisdom (*phronesis*) (Schwartz & Sharpe, 2010).

Phronesis, or practical wisdom or prudence, is a virtue described by Aristotle. It rests on the desire to do the right thing and learn the right competence; it is derived from individual experience and helps us pursue the right action effectively. Practical wisdom is therefore a combination of the will to do the right thing and the ability to act in line with this will. A person guided by practical wisdom knows how and when to make an exception to any rule if circumstances require.

To be able to be guided by *phronesis*, we must be able to improvise and not fall into a rutine. Schwartz and Sharpe say that a prudent person is like a jazz musician. He or she has a musical score with some notes (some rules), but they also have space to improvise, building a moral competence by "bending" or temporarily suspending rules. Too many notes (rules) prevent a jazz musician from improvising (developing their moral competence) or make them lose interest in playing. In this context, a code only becomes a set of guidelines that we can use, but we are also aware that we cannot just follow its instructions blindly.

Practical wisdom can be developed by learning from senior, experienced, and wise colleagues (mentors). There are several moral figures in banking, as noted by Schwartz and Sharpe. The most outstanding figure is perhaps the Nobel Peace Prize winner, Muhammad Yunus, the founder of Grammen Bank and the mastermind of the micro-loan scheme for the poor. For a number of reasons, Yunus is a perfect example here. He needed specialist economic knowledge to create his micro-loan programme. More importantly, Yunus possessed knowledge of people living in small rural communities. Without the trust, support and commitment of people from supported communities, the idea of micro-loans would not have been successful. A similarly noteworthy figure is Ron Grzywinski, one of the founders of ShoreBank, a leading American bank supporting community development, known as CDBs or Community Development Finance Institutions (CDFIs).

Taking care of practical wisdom can help meet the challenges framed by the SQFB. In reality, taking responsibility in accordance with professional ethics can be manifested in practical wisdom; for example, when keeping careful records of customer's income and resources in order to assess their creditworthiness. Practical wisdom will help solve ethical dilemmas in the professional practice of banking sector employees, by finding room for the complexity and ambiguity of moral situations that occur; for example, when assessing whether a loan applicant is trustworthy and whether the risk is worth taking.

Phronesis can help build an attitude that seeks solutions that bring added value to all partners when

deciding how to manage the bank's assets and how to give good advice to customers. Implementation of these recommendations and putting them into practice in professional life can also earn individual people the status of moral models in their team.

Creating good conditions for the development of practical wisdom is not easy. It requires bank managers to offer their staff opportunities to meet the people whom they support. Consent to some degree of improvisation is necessary, which of course,involves the risk of making mistakes and accepting them. Yet fostering practical wisdom can lead to increased satisfaction and internal motivation, and also spawn innovations such as micro-loans. Additionally, encouraging practical wisdom will allow banks to cultivate virtues enumerated at the beginning of this chapter to be guided by them in the right situations and at the right time.

Conclusion

In this paper, I have highlighted various challenges that the banking sector faces in connection with the implementation of ethical requirements recommended by the SQFB. I have also covered the problems generated by the choice of methods so far used to develop moral attitudes among bank employees. When banks make earning money their only goal, they lose the possibility of moral growth. This may fostering a culture of irresponsibility and denial of reality, as was the case before the 2008 financial crisis. Codes are not an ideal tool for promoting moral attitudes; yet, the law, regulations and codes are there to prevent bankers from acting recklessly.

People working in a banking institution cannot be driven only by internal stimuli; some external incentives are also needed to encourage them to work. The banking system depends to a large extent on whether bankers know whom to trust, and whether they are perceived by customers as trustworthy. *Phronesis* is certainly a tool for promoting such a banking system. This virtue must be supported at all levels of an employee's banking career so that the ethical requirements framed in the SQFB become a reality. •

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Beyond the Code of Ethics - Measuring Corporate Culture

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Finalist

Matthew Wharton
United Kingdom
Internal Auditor,
*Euroclear *,*
London (UK)

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

An ethical corporate culture is not created by a code of ethics any more than telling a child not to eat sweets gives them healthy teeth. Culture is more than documents and processes; it is made of perceptions, of feelings and the sense of "how things are done around here". Take any recent scandal: they were not created by individual employees, but by a corporate culture which allowed and even encouraged people to behave unethically.

There was the rationalisation of the fraud; in other words, the attitude that "everyone else is doing it, so it must be ok", the winning at all costs mentality, and the side-lining of those who tried to blow the whistle. So how can that culture have been fostered, and conversely, how can the leaders of tomorrow get assurance that the culture they want and think they have created is actually in place? How can something as intangible as corporate culture be measured?

In the first part of this essay, we will consider three case studies of recent scandals to identify some of the tell-tale signs of a poor corporate culture. It is important to note that all three examples had a mature compliance system with an external whistle-blower hotline, a code of conduct and an internal audit department. So what went wrong?

Case studies Volkswagen

The first case study of how a poor culture can prevail through an organisation is Volkswagen. To re-cap what happened, in 2015 Volkswagen admitted equipping 11 million cars with software to detect

when the car was being subjected to regulatory testing. The vehicle would then enter a low emissions mode, releasing 40 times less nitrogen oxide compared with real-world driving. The original finding was made by the Californian Air Resources Board, which investigated emissions discrepancies between European and US models of the same vehicles.

The Volkswagen board, CEO, and senior management were undoubtedly accountable for this scandal. However, they did not design, test or install the software, which was down to the engineers. So what was the environment that convinced teams of engineers to develop software they knew was unethical and illegal and then for nobody to report them?

Media reports suggest there was a ruthless, authoritarian culture at Volkswagen. The New York Times interviewed an unnamed executive who said: "They only know one way of management… Be aggressive at all times". Furthermore, "the firm is controlled by a tight-knit troika of a billionaire family (Ferdinand Porsche's descendants), a German state government (Lower Saxony) and powerful labour unions. The corporate jet is not just any jet, but a full-size Airbus". (Ewing & Bowley 2015).

"The terrible mistakes of a few people"

When news of the scandal broke, the CEO Martin Winterkorn said the problem was down to "the terrible mistakes of a few people". Board member Olaf Lies said that "the people who allowed this to happen, or who made the decision to install this software acted criminally, and must be held personally accountable". He also said the board only found out about the problems "shortly before the media did".

Matters did not improve once the scandal was full-blown public knowledge. A whistle-blower stepped forward. A former Volkswagen employee filed a lawsuit for wrongful dismissal in March 2014 in the US state of Michigan. The plaintiff alleged that co-workers illegally deleted electronic data for three days after the US government accused Volkswagen of cheating on its emissions test. He was fired for reasons unrelated to the emissions scandal, although he alleged that it was because he refused to take part in an illegal act which would obstruct the course of justice (Ewing 2016).

So what was the culture that allowed this to happen? As can be seen by the responses in the months after the scandal emerged, there was a closed-off leadership at Volkswagen which passed the blame onto a handful of engineers instead of looking at the culture that made it possible. There was a culture of fear at Volkswagen, where employees were unlikely to question the orders given to them and only good news such as "we can meet the

emissions targets" was passed on to management, regardless of how that objective was achieved. Potential whistle-blowers were likely to be too scared of retribution to speak up.

Danske Bank

Our second case study concerns Danske Bank and one of the biggest money laundering scandals of recent times. Between 2007 and 2015 more than €200 billion of suspicious transactions were channelled through high risk "non-resident" (largely Russian) accounts. In 2018 Danske Bank put the root cause down to its Estonia-based branch having a different IT system where documents were written in Estonian or Russian. (Bruun & Hjejle, 2018). The bank noted: "…it was believed within [the] Group that the high risk represented by non-resident customers in the Estonian branch was mitigated by appropriate AML procedures… In early 2014, following a whistle-blower and new reporting from Group Internal Audit, Danske Bank Group realised that there had been a historical misconception."

The bank called it a "historical misconception" but a whistle-blower appeared to disagree: Howard Wilkinson, the head of Danske Bank's Baltic trading unit until 2014. In May 2012, he became suspicious of some of the trading he saw and decided to investigate. One of Danske's clients, Lantana Trade LLP, based in London, had moved $480 million through the branch in the space of five months. Wilkinson paid £1 to download their company accounts, which mentioned the company's net assets as £0.00. This was reported to Danske's compliance team, who responded that it was probably an administrative error and Lantana would be contacted to update their records. Eighteen months later, Wilkinson downloaded the same report and found their assets listed as £15,689, while Lantana's account with Danske Bank had close to $1 million. The next day Wilkinson wrote a letter to Danske bank in Copenhagen: "The bank may itself have committed a criminal offence…. There has been a near total process failure". Two days later he received a reply: "Thanks for drawing our attention to this. It must be investigated asap" (Hope, Hinshaw & Kowsmann, 2018).

It took until the middle of 2014 for the bank's internal audit department to investigate some of the evidence. The report mentioned two findings: The Estonia branch's head of international banking had said that employees were not recording the true owners of the companies because "it could cause problems for clients if Russian authorities request information". It also mentioned that the Estonia branch was not able to identify the true source of funds and "therefore acts against [anti-money-laundering] legislatory principles" (Hope, Hinshaw & Kowsmann, 2018).

> “The acts, which lasted for years, were systematic, coordinated and targeted, always targeted on making money”

Despite this conclusion, a full investigation only started in 2017, three years after the audit report. The investigation largely exonerated Danske’s top management, including the then CEO Thomas Borgen. It did, however, note that 42 employees and agents “have been deemed to have been involved in some suspicious activity” and reported to the regulator (Bruun & Hjejle 2018). Since December 2018, 10 Estonian employees have been arrested, with Estonia’s head of criminal police saying: “The acts, which lasted for years, were systematic, coordinated and targeted, always targeted on making money” (Tallinn 2018).

What we can see is a lack of oversight by Danske’s group management, as if their only interest was the money the branch was bringing in. Yet not knowing about the fraud, while ignoring the warnings and reaping the benefits, does not excuse them, given the whistle-blower accusations, internal audit report and the fact that a small branch had a turnover higher than Estonia’s entire GDP. Danske’s management had set a culture which prioritised balance sheets over ethics and allowed executives to rationalise the fraud as acceptable practice.

Wells Fargo

Continuing with the financial services theme, in September 2016 the US bank Wells Fargo was fined $185 million by the Consumer Financial Protection Bureau (Wikipedia 1), for opening savings accounts, credit cards and insurance policies without customers’ consent.

Wells Fargo set employees high targets to cross-sell products; for instance, if someone applied for a current account, employees were expected as well to try and sell the applicant a credit card or a loan. The strategy aimed to persuade customers to open extra accounts which would generate more revenue. However, in pursuit of the strategy, employees fraudulently opened accounts which ended up dormant. Approximately 95% of these accounts were unfunded and thus brought in no revenue, while the remaining 5% brought in about $2.4 million. This was small change for a bank of Wells Fargo’s size, and considerably less than the fines that would come.

So it appears that Wells Fargo had a poorly thought out incentives programme and a decentralised structure with poor oversight of its separate entities.

The board’s independent directors investigated, and reported on the issue in April 2017. They summarised the culture well:

“The root cause of sales practice failures was the distortion of the

Community Bank's sales culture and performance management system, which, when combined with aggressive sales, management created pressure on employees to sell unwanted or unneeded products to customers and, in some cases, to open unauthorized accounts. Wells Fargo's decentralized corporate structure gave too much autonomy to the Community Bank's senior leadership, who were unwilling to change the sales model or even recognize it as the root cause of the problem. Community Bank leadership resisted and impeded outside scrutiny or oversight and, when forced to report, minimized the scale and nature of the problem…Many employees felt that failing to meet sales goals could (and sometimes did) result in termination or career-hindering criticism by their supervisors. Employees who engaged in misconduct most frequently associated their behaviour with sales pressure, rather than compensation incentives" (Independent Directors of the Board of Wells Fargo, 2017).

In other words the culture was created by an aggressive management who instilled fear in their employees to meet arbitrary, and in some cases, harmful sales targets. They felt the only measure of success was the amount of accounts that were opened per day. The only way employees could satisfy this measure and not be fired was to create fraudulent accounts. Any new employee was exposed to a culture where "everyone else is doing it so it must be ok, or at least, better than losing my job"

The signs of poor corporate culture

Using our three case studies, what are the signs of a poor corporate culture? Some themes stand out:

Fear: Senior management not being willing to listen to internal or external feedback; employees not being able to raise their concerns; management not leading by example, but getting employees to follow orders through fear.

Targets: Management setting unrealistic targets, and sticking rigidly to performance metrics which do not help to achieve the organisation's goals.

Incentives: Remuneration that has a high degree of uncertainty, with a large variable element in bonuses or commission.

Rationalisation: Lower level employees do not realise the consequences of their actions. Senior managers see that unethical behaviour is tolerated if objectives are met or that they are not accountable if they turn a blind eye. The culture becomes self-perpetuating.

Poor oversight: Small subsidiaries or branches may not need the same oversight as larger functions in an organisation. Yet they should still be investigated where red flags are spotted, such as when a small entity generates disproportionate revenue.

We now know what a bad

corporate culture can look like and with hindsight it is easy to identify what went wrong. The challenge is looking forward: How can the leaders of tomorrow measure corporate culture in the workplace? And what metrics are already out there to help them?

Internal auditors

Internal auditors have a key role in passing information on company culture up to the board and senior management. They have a unique, independent view across all levels of the organisation. Through their audits, they speak to everyone from CEOs to managers to the most junior employees who are just starting in the company. The internal audit profession is increasingly looking at questions of ethics, culture and tone at the top, beyond simply ticking boxes and checking signatures. So if we want to learn about measuring culture and ethics, it is important to see how internal audit teams can feed into our assessment.

Of course what we can obtain from an internal audit team depends on its maturity its mission as set by the board. But they could, for example, include culture as a reported part of each audit, or they could perform a specific enterprise-wide culture audit. We could use the results of this work in our culture measurement programme, and as the internal audit profession already focus on these areas, we could also use some of the same techniques.

Fortunately, the Institute of Internal Auditors provides guidance on precisely this issue and suggests four techniques (Roth 2017): The first is root cause analysis of previously raised issues. Under close scrutiny, the root cause of an issue is often cultural. For example, if procedures are not being followed due to management overriding controls, this could be due to a "win-at-all-costs" culture where managers do what it takes to get the job done; or to an authoritarian regime where management's say is final. This could be an isolated case, where one manager's aggressive subculture does not match the company's culture. Or it could be pervasive, connecting the dots between numerous issues that shed light on a defective corporate culture.

Using interviews and questionnaires

The second and third techniques are structured interviews and employee questionnaires. The two techniques have similar aims but different approaches: to ask employees specific questions to obtain their version of the company's culture. The idea of a structured interview is to ask the same set of questions to as large a sample of employees as is practical.

Being a face-to-face interaction, it requires good interviewing techniques; for example, it should start with some questions to put the candidate at ease, such as "do you feel the company's values are lived through the organisation?" The

interviewer can then move on to more pointed questions, like "have you ever been asked to do anything that violates the companies code of conduct?"

This approach does have disadvantages, however. As mentioned, it takes a skilled interviewer to be able to ask the right questions in the right way, and interpret the results correctly; for example, to detect when an employee is not being completely open, and thus ask the right follow-up questions. Due to the time needed, sample sizes cannot be as large as employee questionnaires.

Questionnaires take a similar approach by asking a sample of employees a specific set of questions. They can, however, reach a far larger number than interviews. Such questionnaires are often composed of a series of statements followed by a question asking whether the interviewee strongly agrees, agrees, disagrees or strongly disagrees. A well-constructed questionnaire can provide specific objective data on the company culture, so long as employees believe their anonymity is protected. On the other hand, they lack the human touch and the possibility for the interviewer to ask follow-up questions or seek a clarification from the interviewee.

The fourth technique is to leverage metrics which can reflect culture. Using these metrics along with the above techniques can bring objective evidence of any cultural issues. Relevant metrics could include customer survey results, the number and trend of customer complaints, employee turnover statistics and operational incidents. The selection of the statistics used will depend on the industry and the company itself. It is also possible to monitor them regularly and produce a monthly dashboard which can act as an early warning indicator. Yet statistics alone will not give an overview of a company's culture. They must be used in conjunction with other techniques.

Now we understand some of the techniques auditors can use, what other theories and techniques are available?

Using formal surveys

As discussed above, one of the most obvious ways to measure culture is by asking people. However, to obtain consistent, measurable answers requires a structured approach, and to get results from the whole company, we will need to use a questionnaire. There are plenty of consultancy companies which sell different types of employee questionnaires to help you create your own. Let us consider some of the psychological information and logic behind these surveys.

In his book *Ethicability* Roger Steare identifies three types of ethics (Steare, 2013): the ethics of obedience, care and reason. These relate to the decisions you make and the reason you take them. For example, if you have a job that you

love, but one day your boss verbally abuses a colleague, reducing them to tears, do you decide to report this incident:

a) because there are HR procedures that are there to deal with such incidents;

b) because others may suffer if you don't take action;

c) because you would rather risk your job than allow that type of behaviour?

Answer A relates to the ethics of obedience. It does not ask us to decide what is right or wrong; it tells us. Answer B relates to the ethics of care; what decision will benefit the most people and what are the consequences of our actions on others? Lastly, answer C relates to our ethic of reason. We do what is right because it is the wise or moderate thing to do. None of these answers is more correct than the others, but they show us how we shape our decisions of what is right and wrong.

Steare created his own survey to measure the prevalence of these types of ethics, along with 10 principles for integrity: wisdom, fairness, courage, self-control, trust, hope, love, honesty, humility and excellence. This survey has been completed more than 80,000 times globally, and gives us an insight into ethics and culture across industries. The most striking point to note from these results is that the ethics of reason and obedience are inversely correlated. As we mature, our ethics of reason increases and our ethics of obedience decreases. So the more we develop our ethics of reason the less we need to comply with the ethics of obedience. That is consistent with Kohlberg's theory of moral development (Wikipedia 3); namely, the more rules we have, the less we will think about what is right.

Are fewer rules better?

In the case studies above, people did not go astray because of a shortage of rules. On the contrary, there were plenty. A good analogy is that of a roundabout. In Europe, it has been demonstrated that the roundabouts are safer and more efficient at regulating vehicle flows than traffic lights. The latter are the equivalent of a rule: Go or do not go. The roundabout pushes the driver to exercise judgment about when it is safe to go. Think how many times you have entered a junction at a traffic light, and not been able to exit the other side. Would you have done that if the traffic light had not been there?

This does not mean that the key to good ethics is throwing out the rule book. But does giving people the freedom to think what is right or wrong within a given set of parameters improve people's ability to make good decisions? The evidence seems to support this hypothesis..

In *Organizational culture and leadership*, Edgar Schein wrote that there are three levels of culture

(Schein, 1992). Like peeling an onion, it becomes harder to change a culture the deeper one penetrates. The first layer is "artefactual", meaning things like the visible signs, the company logos, buildings and dress codes. The second, "espoused values", refers to what people say and believe. The last layer refers to "underlying assumptions" regarding our core beliefs and the way we see the world.

Artefactual values are fairly easy to measure, as things we can see. It is likely that metrics exist for such values. Surveys and interviews can be used to measure espoused values which can help reveal employees' attitudes towards risk and, a company's leadership and priorities. However, cultural areas which cover underlying assumptions can be harder to measure.

Take "integrity" as an example. Unethical behaviours can become normalised so they are accepted or not even noticed, and therefore not reported. Here we need to think of some alternative ways to obtain insight.

Dr Alex Gillespie and Dr Tom Reader from the London School of Economics suggest one uses "unobtrusive indicators of organisational culture". These analyse data from already available sources (Gillespie and Reader 2017). Examples include Glassdoor.com reviews by employees, where they can anonymously leave reviews on issues such as salary, management, and the work-life balance; response time to customer calls to measure how customer-centric employees are or if they are being pushed to take calls outside working hours; and linguistic analysis of emails between employees, searching for data such as high levels of aggressive language in a particular area.

Metrics

As mentioned already, we need metrics to complement the results of our survey and provide regular data. These metrics will be similar to existing KPIs and this will help with the implementation. So it is worth highlighting some of the best practices and pitfalls with KPIs.

Firstly, keep it simple. Implementing a culture measuring programme will not work if it merely burdens business units with more data collection Try to use what is already available.

Secondly, any KPI can be manipulated, however well designed. As the Wells Fargo fraud demonstrates, KPIs are indicators, not fool-proof measures, and any insights from KPIs should bear this in mind. There is no point calculating complicated formulas that give your team a culture score of 75.6 and a yearly target of 77. The KPIs will be manipulated and you will lose all insight into the data.

Furthermore, some metrics also resist precise target scores. Take the number of times the whistleblowing hotline is called. This is a good

indicator of culture and of course having a lot of calls is a bad sign. But so is having no calls; it means the hotline is not known or it is not at the front of employees' minds. Ideally, the target should be somewhere between "no calls", and "lots of calls". Setting an arbitrary target of ten calls a year is easily manipulated and reveals nothing. Instead, it is much better to have an expected measure of between five and 15 calls a year. This is not a target but an indicator of where there might be hotspots of poor culture. Once they are identified, you need to use human judgement, go to the area in question, talk to people, and find the story behind the figures.

What to measure?

We now know the techniques we want to use, so let us drill down to the details of implementation in an organisation. First, though, an organisation needs to define what culture it wants. This can relate to values or the company's mission, but it has to be honest. If you want a culture where employees come first, and work-life balance, support and mentorship are all important, you are unlikely to be ruthlessly efficient at the same time.

Having defined the desired culture, there are three main areas of focus during implementation:

- employee feedback
- companywide metrics
- business unit metrics

These can then be combined to give an overall view of company culture, but also to identify areas where there may be a need to dig deeper to uncover concerns. To be clear, the following is not meant to be an exhaustive list of all measurement techniques. There is no one-size-fits-all; instead they are ideas, to spark thinking about implementation in your company.

Employee feedback

Here we can focus on two areas: "asking people", and "asking people who ask people". The first, "asking people" has already been discussed at length. The specifics of what to ask, how to ask it and how to interpret the results are the subject of much study. The drawback to surveys is that they are usually conducted annually and are expensive to perform. However, a well-designed survey can be the cornerstone of any measurement programme.

The second area is to ask people who ask people. Here we can use a company's internal audit department to provide the insights we need. They can dig deeper in specific areas and have the skills and resources to use interview techniques. The feedback will depend on the internal audit department's mission. The department could simply provide highlights of audit reports for you to analyse for areas of attention. Alternatively, it could provide specific information, such as the results of a root cause analysis of issues raised by the audit, to find common culture-related themes. Lastly, it could

include a cultural element, providing statistics in areas such as audit report clearance times or the time elapsed for management to close issues identified by audits.

Company-wide metrics

These are statistics that are generic across all business lines. With the same statistics across the company it becomes easy to make comparisons. We can include some traditional statistics such as:

- number of calls to a whistle-blower hotline
- employee turnover and dismissal rates
- negative employee exit interviews
- employee overtime rates
- risk/compliance training attendance
- remuneration statistics, such as the difference between executive and employee pay, or the percentage of salaries paid in bonuses or commissions

We can also add some more contemporary measures. We can scan Glassdoor.com (the website where employees leave confidential reviews on their employers) for negative reviews. One interesting technical measurement is linguistic scanning of employee communication such as emails or chat messages for specific types of language.

KeenCorp (KeenCorp.com) has developed software which anonymises employee communication, scans it and measures employee engagement through "language analysis and tension detection" based on how people write. It then reports back with a heat map of potentially problematic areas, with the data anonymised and in compliance with European GDPR legislation.

Business Unit Metrics

This tries to use the business units own KPIs, which can vary wildly across other business units and organisations. You will need to rely on the division management to define their own KPIs and their level of tolerance. They can be guided by teams such as Compliance and Ethics, but the ownership must lie specifically with the relevant business unit. Some generic examples could be:

- profit margin ratio
- number of client complaints
- number of clients granted credit now in arrears
- number of management-accepted risks
- maturity of continuous improvement initiatives (which often have employee feedback to management at the heart)
- number of management-approved exceptions to procedures
- number of procedures

Conclusion

So can we measure corporate culture? I would argue no. "Measure" is the wrong word, because it implies that we can arrive at precise, measurable figures and create management reporting that receives and assesses indisputable facts. If we measure, we get statistics and targets. Our reports might say "we have a turnover of $10 million and a culture score of 72. The following year we intend to increase these by 10%". Metrics would be manipulated, surveys answered "correctly" and any insight lost.

What we can do, however, is create cultural indicators. We investigate if metrics fall outside expected boundaries. We do not set arbitrary targets. We try to understand the story behind the figures, which might point to evidence of poor culture. On the other hand, perhaps the fluctuations are for perfectly acceptable reasons.

It is up to you how to implement a cultural indication programme. This paper has offered some insights and concrete examples, but the specifics will depend on each organisation and industry. My best advice is to not over-complicate or burden the business lines; use what is already available. It will not be a fail-safe way to avoid any type of fraud in the future, but hopefully it can detect problem areas and allow action to be taken to prevent a culture where fraud is considered acceptable.

Instead, the goal is to create a culture driven by the ethics of care and ethics of reason, where profit is not the only motive and we seek to help the communities we serve. Only then can we look to improve the image of an industry that since the financial crisis has ranked among the least trustworthy, along with politicians, journalists and estate agents. That alone should be sufficient motive to take action. •

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The Moralisation of Contracts: An Islamic Persperctive

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Special Commendation of the Jury

Andrea Bancone
Italy
Global Custody Analyst,
Euroclear Bank,*
Brussels (Belgium)

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

In the wake of the 2008 Global Financial Crisis (GFC), perhaps the greatest downturn of the global economy since 1929, many Islamic financial professionals were ready to claim that history had proved the divine footprint of Islamic Finance principles and *Shari'ah* at large. Not a single Islamic Financial Institution (IFI) was impacted by the collapse of subprime mortgage bonds and the cascading effects it generated at a systemic level among the network of banks which were exposed to highly leveraged markets blighted with toxic assets, derivatives and all sorts of complex financial devices which were structured in Western countries and which shifted the object of their investments too far ~~from the real economy.~~

Today Islamic Finance assets are worth $2.2 trillion dollars worldwide and are forecast to reach nearly $4 trillion by 2022 (The Business Debate, May 2018). Targeting a market of approximately 1.6 billion Muslims around the world and offering their services to non-believers as well, Islamic Finance firms have reached Western countries, with major European hubs in France, Germany and the UK. They are currently competing, albeit quietly and not always holistically, with conventional financial institutions (The Economist, October 2018).

This paper will focus on the analysis of Islamic Finance theory and practice as opposed to conventional finance. If we are to investigate the financial service's industry's ethical drivers, or debate their shortcomings, then it is worth confronting them with a model that proudly declares itself an alternative

to Western secular finance by being founded on the moral principles of the Islamic faith and *Shari'ah*.

As Islamic Finance has gained momentum since 2008, questions have arisen about whether *Shari'ah*-compliant financial services firms provide for greater ethical awareness and outcomes in their business practices. Could the GFC have been avoided if the financial services industry observed *Shari'ah* principles? How will IFIs react when the risk of default materialises?

To answer these questions I will first explain the pillars on which Islamic financial regulation is based. I will then move on to showcasing how Islamic financial practitioners and jurists have worked towards the creation of *Shari'ah*-compliant financial products. In this regard, *Shari'ah* scholars play a crucial role in that each Islamic financial services firm must appoint a board of *Shari'ah* experts who will ultimately judge the permissibility of the products and services offered by the industry. As I will show, the ethicality of the Islamic Finance industry is located in the structuring phase of a deal, what I like to call the Moralisation of Contracts. In that sense I maintain that the Islamic model of capital financing is inherently formalistic; it cannot ensure that the morality of agents will follow from the morality of contracts. In the last sections the case of Dana Gas default procedure will be presented to support the arguments discussed in this paper and to outline the ethical issues that may face Islamic Finance when exposed to a specific type of risk that does not affect conventional financial firms: namely *Shari'ah* non-compliance risk.

Islamic Finance Pillars

The complexities of Islamic normative and ethical frameworks are mainly the outcome of what has been referred to by sociologists and philosophers as legal pluralism, a phenomenon reflecting the coexistence of multiple legal or normative authorities and sources of law within a given region or state. Malaysia is a good example of a plural legal system where the federal constitution provides for a dual legal framework of *Shariah* laws applying to Muslim citizens and secular criminal and civil laws applying to non-Muslims.

The definition of Shari'ah is itself problematic due to the constant tension between its interpretive and literary nature. As will be shown, this tension is the fulcrum of current debates among traditionalists and reformists in Muslim countries.

There are four main sources of *Shari'ah* commonly reported in Islamic law texts: the *Qur'an*, the *Sunnah* (practice) of the Prophet, *Ijma'* (Scholarly Consensus) and *Ijtihad* (Independent Juristic Reasoning). While the *Qur'an* provides basic principles regarding how life on earth is to be lived, the *Sunnah* demonstrates through the Prophet's practice how these

principles are to be implemented. As reported by Abdur Rashid Siddiqui, *Ijma* and *Ijtihad* are often grouped together to represent a legal term which refers to the use of reason and judgement to determine *Shari'ah* rulings (Siddiqui 2018). These come into operation when both the *Qur'an* and the *Sunnah* are silent on a particular issue. Nowadays small groups of scholars and jurists may reach a consensus over a specific topic; however this consensus will only be accepted globally when an assembly of world-renowned jurists and scholars endorses it.

Islamic law with regard to Islamic Finance is mostly defined as *fiqh*, or Islamic jurisprudence. This definition has its origins in the colonial era when *fiqh* was institutionalised as the authoritative approach to Islamic law by European scholars and became the dominant form of applied religious knowledge in contemporary Islamic finance (Rudnyckyj 2019). *Fiqh* is often described as the human understanding of the *Shari'ah*. Whereas *Shari'ah* is considered immutable and infallible by Muslims, *fiqh* is considered fallible and changeable. As will be shown, changes in the interpretation of a specific aspect of *Shari'ah* will not come without ethical concerns regarding the general practice of the Islamic Finance industry.

Justice in Exchange: Islamic and Christian Views on Trade

In order to understand how Islamic finance is structured, consideration must be given to a number of principles defining the philosophy that underlies transactions and exchanges in Muslim countries.

In a lecture at the University of South Australia (2013), Professor Mervyn Lewis traces back the philosophy of transactions to the anthropological aspects of Muslim and Christian societies and explains how these aspects led to an earlier development and definition of justice in exchange in the former.

Christianity developed in feudal societies, where most transactions were in kind and the Church was a major land owner which accounted for 50% of production. By contrast, Islam was born in the merchant towns of Arabia; exchange and market transactions were therefore an everyday part of life. In this regard, one of the most popular passages from the Bible is emblematic, describing Jesus's reaction towards the merchants in the Temple: "The crowds replied, 'This is Jesus, the prophet from Nazareth in Galilee.' Then Jesus went into the temple courts and drove out all who were buying and selling there. He overturned the tables of the money changers and the seats of those selling doves. And He declared to them, 'It is written: 'My house will

be called a house of prayer.' But you are making it 'a den of robbers'." (Gospel of Matthew 21:12).

Conversely, a market economy existed in Muslim countries; therefore, Islam had to come to terms with the market and so the principle of justice in exchange was defined: "trading was extolled, the forms of unjust exchange elucidated and a system of just exchange was mandated" (Lewis 2013). Licence to trade culminates with the verses in *Surah AL-Baqaran*, the second and longest chapter of the *Qur'an*: "Those who devour usury (*riba*) shall not rise again [on the Day of Resurrection] except as he rises, whom Satan of the touch prostrates; that is because they say, 'Trade is like usury (*riba*).' But Allah has permitted trade, and forbidden usury (*riba*)." (*Qur'an* 2:275).

In the first place, Islam does not recognise the time value of money. A dollar is worth the same today as it will be worth in three months' time, should one decide to lend it to a borrower. Money is not to be seen as a commodity either; when purchasing and selling products, money does not change hands until the item being purchased is delivered.

Closely linked to this principle is the *Qur'an's* strict prohibition against the collection of interest or *riba*, which is sometimes also translated as usury or exploitation. This prohibition originates from the belief that money and profits are earned. To charge interest is considered an unrighteous gain since the financial institution is only profiting from its ability to lend money.

The third main principle is the avoidance of *gharar*, often referred to as uncertainty or hazard and any activity linked to gambling and speculation. When entering an Islamic contract, the price, quantity, and time of payment must be known in advance by the parties. It is therefore no wonder that many of the products and practices currently accepted in Western countries, such as futures, derivatives, short-selling, interest- bearing products and even money market devices are not tolerated in Muslim countries.

Last but not least, pious Muslims cannot invest in products that are considered *non halal* like alcohol, drugs, tobacco and certain foodstuffs.

No Risk No Gain: Unconditional Rewards and other Dangerous Aspects of Debt-Based Economies

Islamic Finance professionals seem to locate the root cause of detachment from the real economy in the practice of lending at interest.

The main objection against *riba* is that it represents a gain that is fixed and certain in exchange for what is uncertain, such as the success of a venture. A financer will still be entitled to claim returns even if the venture fails. As will be shown, this sets the ground for a major *moral hazard*. There are at least 12 verses in

the Qur'an dealing with *riba*, with the very first one claiming: "And what you give in usury *(riba)*, that it may increase upon the people's wealth, increases not with God". (*Qur'an* 30:39).

This verse suggests that an economy based on interest will only make the wealthy wealthier and the poorer, poorer. It basically keeps on strengthening the position of stakeholders who are already favoured in contractual terms.

Islamic Finance professionals provide additional reasons why lending at interest is considered morally unjust and dangerous. As they argue, conventional lending institutions can be defined by the practice of *risk transfer.* Despite benefitting from several years of low tax regimes, Western banks have always sought ways to minimise their risk exposure to the detriment of customers, requiring collateral in exchange for credit, as well as to the detriment of tax payers if they need a government bail-out. In a landscape where profits are certain and losses are almost always compensated by collateral or public funds, it is no wonder that secular financial institutions have crossed so many lines. This is the moral hazard that follows in an economy heavily reliant on interest-linked products.

Instead, a more balanced exposure to risk will result in greater moral consideration and outcomes as outlined in the legal maxim *Al-ghurm bil ghunm,* or "There is no reward without risk."

Interestingly the assumption of risk plays the role of a moralising agent in Islamic Finance. As will be shown in the next section, every contract, to be considered *Shari'ah*-compliant, must elucidate the elements of risk undertaken by the signatories.

Shari'ah-Compliant Debt: A question of *Maquillage?*

To circumvent the limitations imposed by *Shari'ah* on interest, models of financing based on debt have been structured in the form of a sales contract that allows lending institutions to make a profit rather than collecting a fixed income.

There are three major ways Islamic Finance can structure a loan that is compliant with *Shari'ah* rulings: *Murabaha*, a sales contract where a bank will purchase an asset on behalf of its clients and sell it back at a mark-up price on a deferred payment basis; *Ijarah*, generally defined as an operational lease, where ownership of the tangible asset remains with the lessor, usually a bank that purchases a good, its usufruct being transferred to the lessee for specified rental payments incorporating profits; and *Sukuks* or Islamic Bonds, which are financial certificates defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as securities of equal denomination representing individual ownership interests in a portfolio of eligible existing or future assets. The *Fiqh* academy of

the OIC (Organisation of Islamic Cooperation) legitimised the use of *Sukuk* in February 1988 (Wikipedia). The risks assumed in these types of contract are the ones associated with the sale of a commodity for money in the case of a *Murabaha* structure or the termination of a lease and duty of repair which the lessor is committed to in an *Ijarah* deal.

The most popular *Sukuks* are those structured in *al-ijarah* contracts where the Originator holds assets that are the basis of return, the assets are then sold to a Special Purpose Vehicle (SPV) and leased back. SPVs sell *Sukuk* certificates to investors. Each certificate represents a share in ownership of the assets. Periodic distributions are paid to investors from rental revenues. This type of instrument is also transferrable at a mutually negotiated price, thereby allowing secondary market trading. These products can nowadays provide returns that are fixed like any interest-based instrument.

It comes as no surprise that, insofar as Islamic financial devices have been developed to replicate the performance of conventional finance products, many academics and *Shari'ah* scholars have fiercely criticised the massive use of debt-based products and the formalist approach of Islamic financial practitioners that define as permissible any action or object not explicitly forbidden by the scriptures. Criticism comes in different wordings, from the more politically correct "*Shari'ah*-Compliant" as opposed to Shari'ah-Based, to "Creative *Shari'ah* Compliance", which appeared in a recent publication by Ahmad Alkhamees (2017), to the more explicit attack of Rumee Ahmed in his publication "Shari'ah compliant: a user's guide to hacking Islamic law"(2018).

Authenticity: A Debate on Substance for the Islamic Finance Industry

Supporters of a reformist approach have sought ways to reach beyond form to substance, lamenting the fastidious attention paid towards formal aspects of *Shari'ah* in the Islamic Finance industry, which has practically turned into the *halal* equivalent of its Western counterpart without showing significant differences in the way capital is being financed. As they claim, in order to tackle substantive aspects of Islamic Finance, the industry should be grounded in the wisdom revealed by *Shari'ah* and its objectives, a concept known as *Maqasid al Shari'ah*.

The best definition of the objectives of *Shariah* was provided by a prominent XII century theologian, philosopher and jurist of Islam: "The very objective of the *Shari'ah* is to promote the well-being of the people, which lies in safeguarding their faith (*deen*), their lives (*nafs*), their intellect (*naql*), their posterity (*nasl*) and their wealth (*mal*). Whatever ensures the safeguarding of these five serves the public interest and is desirable, and whatever hurts

them is against the public interest and its removal is desirable." (Abu Hamid al-Ghazali d.1111 CE) Models of financing based on participatory exposure to risk in the Profit and Loss Sharing (PLS) model, via means of equity-based instruments, have been endorsed as truest to the principles of Islamic faith, drawing from the renewed interest in *Maqasid al Shari'ah* and linking it to the fundamental principle of 'no risk, no gain' underlying Islamic transactions.

The most commonly used contracts in the form of Profit and Loss Sharing are:

1. *Mudaraba*: an investment partnership whereby the *Rab ul Mal* (investor) provides capital to the *Mudarib* (entrepreneur) in order to undertake a business activity. While profits are shared on a pre-agreed ratio, loss of investment is borne by the investor only and the *Mudarib* loses its share of the expected income and the time/ work invested in the commercial project.
2. *Musharaka*: a joint enterprise or partnership structure in which partners share in both the profit and losses of an enterprise. This contract allows for the financier to achieve a return in the form of a portion of the actual profits earned according to a pre-determined ratio.

Mudaraba and *Musharaka* are seen as structures that are truly compliant with the Islamic principle of risk sharing, in that only the ratio for profit is guaranteed. However, revenues mainly depend on the performance of the business which cannot be known in advance. These models should represent the major source of capital financing according to Muslim reformists. Nonetheless, studies have shown how PLS has gradually declined in use to 6.34% of total financing, down from 17.34% in 1994-6 (Khan M. Mansoor & M. Ishaq Bhatti).

There are obvious reasons why PLS contracts have proved hard to implement compared with debt products. Firstly, in order to allow a wide distribution and usage of these modes, Islamic banks have to turn into venture capital platforms and apply specialised accounting and reporting skills that are typical of private equity firms. Such processes are notably costlier and time-consuming compared with debt-based instruments.

Secondly, PLS structures cannot effectively meet industry demands for project financing, home financing, liquidity management and consumer credit. Last but not least, due to information asymmetry between the financer and the entrepreneur, the moral hazard shifts onto the latter, who may report less profit to the bank than they have actually earned in order to keep a greater revenue stream for themselves.

When Things Go Bad: Testing the Ethical Resilience of Islamic Finance

A detailed analysis of the arguments provided by both Islamic traditionalists, who support the issuance of debt-based instruments, and by Islamic reformists, who endorse models of financing based on the participatory exposure to risk via means of equity-based products, leads to the conclusion that the ethicality of the industry is located in the structuring phase of a deal: what I call the Moralisation of Contracts. In that sense, I maintain that both approaches are inherently formalistic and do not provide sufficient grounds for the elucidation of moral action.

Just as the financial resilience of banks is scrutinised by stress-tests, an effective way to prove the ethical resilience of this model would be to test it against distressed circumstances. If *Shari'ah*-based financial institutions were able to provide a better response in critical circumstances than their conventional counterparts, then a case could be built that Islamic Finance principles and practice are more solid than secular ones.

Dana Gas: A Case Study on *Shari'ah* Risk and the Moral Uncertainty of Default Procedures in Islamic Finance

The case of Dana Gas, a natural gas company in the Middle East with a public listing on the Abu Dhabi Securities Exchange (ADX), is emblematic of the debate about morality and trust in Islamic Finance. The company issued a convertible *sukuk* in the form of a *Mudarabah* contract in 2007 for a total of $1 billion, with maturity in 2012 offering a profit rate of 7.5%. When approaching maturity, following a period of distressed circumstances, the company defaulted in October 2012 and in November 2012 announced it had reached a restructuring agreement with *sukuk* holders. Despite the restructuring agreement, the company faced a number of other critical challenges after 2012 that prevented it from fully overcoming its financial problems. Fearing that it might not be able to fulfil its payment obligations, Dana started discussions with holders about a possible second restructuring of the *sukuk* in May 2017. The terms of a second restructuring seemed less favourable for the *sukuk* holders who were less willing to let it pass without further negotiations. However, after preliminary discussions among parties and their legal representatives in the second week of June 2017, Dana Gas announced that the *sukuk* was no longer *Shari'ah*-compliant in the UAE due to changes in the interpretation of *Shari'ah*. In consequence, it would not distribute upcoming payments due to the unlawful nature of the *sukuk*.

This led to a conflict of jurisdiction in that the *Mudarabah* agreement underlying the *sukuk* structure was regulated by UAE law, whereas the Purchase Undertaking, the part of the *sukuk* contract, was governed by English law (Zada & Muhammad, 2018). Regardless of which law will eventually prevail,

this case elucidates the meaning of *Shar'iah* Risk and sets a precedent with no shortage of moral concerns:

1. On the one hand, there are no clear guidelines defining retroactivity in *Shari'ah*. Fairness of retroactivity in law is perhaps one of the most controversial matters in all jurisdictions and has been formally addressed by Western cultures in the legal maxim *Nullum crimen, nulla poena sine lege* (there is neither crime nor penalty without a law). If a new interpretation of *Shari'ah* enters into force, should this affect the previously agreed terms and conditions of a deal? In order for Islamic Finance to be trusted by a larger spectrum of potential investors and its own community, the question of retroactivity should be tackled by both governmental and religious authorities.

2. The sudden change of behaviour by Dana Gas Management, which switched from negotiating with *sukuk* holders to claiming nullification of its payment obligation by virtue of *Shari'ah* non-compliance, raises concerns about whether the decision was made out of zealous observation of the law rather than convenience. Islamic faith does not encourage judgement about human intentions; to safeguard the unity of the Islamic community, it is desirable not to ruminate on suspicious thoughts about other believers, as elucidated in a passage of the *Qur'an*: "Oh you who have faith! Avoid much suspicion. Indeed some suspicions are sins" (Surah Hujurat 49:12).

Other passages in the Qur'an openly suggest that ultimately, the judgement of human intentions is mandated to Allah. Now, if we allow questionable behaviour to go morally unchecked, inasmuch as they are governed by a legal and religious framework, we incur the formalistic risk of equating legality with justice, which eventually leads to moral self-licensing. This represents a dangerous slippery slope for moral consciousness and a very tangible one, as witnessed during the Holocaust. When confronted with war crimes allegations in Israel, Otto Adolf Eichmann, the Nazi operative responsible for organising the transportation of millions of Jews to concentration camps, based the legitimacy of his deeds on the grounds of an authoritarian system made of hierarchies and commands to which he was subordinated and therefore unable to take any moral stance on the genocide he was helping to perpetrate. His position was analysed in *Eichmann in Jerusalem: A Report on the Banality of Evil* (Arendt, 1963).

Shari'ah non-compliance risk presents a unique problem for the Islamic Finance industry as it cannot

be measured by statistical modelling in the same way that one can calculate market or credit risk. The unpredictability of *Shari'ah* rulings may have consequences at a systemic level.

In 2008 the *Shari'ah* board of AAOIFI ruled that 85% of the *sukuk* under issue around the world were not compliant with *Shari'ah* (Maurer, 2010). The main reason behind that statement was that most *sukuk* were asset- based rather than asset-backed, meaning there was no legal transfer of ownership of the underlying assets to holders who would not have recourse to liquidate them in the event of a default. As in the case of Dana Gas, it is not hard to imagine what would happen if 85% of *sukuk* issuers were to nullify their payment obligations at the same moment, due to *Shari'ah* non-compliance rulings. This would have consequences as dramatic as the GFC for financial stability in Islamic Finance countries.

Innovation and other Challenges for Islamic Finance Institutions

In his recent publication "Beyond Debt: Islamic Experiments In Global Finance", Professor Daromir Rudnyckyj (2018) eloquently unfolds the experimental ethos of Islamic Finance practitioners and scholars who join forces to create authentic financial devices that meet the religious requirement imposed by Shari'ah.

One key aspect of innovation for Islamic Finance is the implementation of standards to allow the use of derivatives for hedging. Use of derivatives would improve its overall credit-worthiness, as it is most actively used in real estate and energy markets.

On the other hand, a 2015 study by the IMF detected a number of regulatory issues which raised concerns about the soundness of the Islamic Finance industry. To name a few:

1. An important challenge is to ensure that profit-sharing investment accounts (PSIA) at Islamic banks are treated in a manner that is consistent with financial stability. Many regulators treat them as deposits, which undermines their loss and liquidity absorbency features.

2. Islamic banks appear well-capitalised, but there are challenges with the implementation of the Basel III Accord, due to the scarcity of *Shari'ah*-compliant high-quality liquid assets.

3. Islamic Finance raises a number of taxation issues. These include tax incentives for debt over equity, the tax treatment of sales, and additional layers of transactions in some instruments. Moreover, differences in the treatment of Islamic and conventional finance, if unchecked, can create cross-border spill-overs and encourage international tax arbitrage.

More generally, the IMF study pointed out the need for greater regulatory harmonisation in Islamic Finance, especially for cross-border operations. Some even argued that standardisation of *Shari'ah* interpretation is desirable. The author disagrees. By its nature, a textual interpretation is in the intellectual domain and should be kept free from restrictions. Besides, it would prove hard to implement, due to the many schools of thought regarding *Shari'ah* and *fiqh*.

Instead, a global agreement on how to manage the effects of *Shari'ah* non-compliance must be reached that minimises the risk of financial loss for investors. In this regard, the AAIOFI should play a major role in strengthening its powers, encouraging greater adoption of its standards by member countries.

At present, out of 45 AAIOFI member countries, only 12 have adopted its standards as mandatory regulatory requirements. Regardless of such adoption, the AAIOFI does not have the financial sanctioning powers of a regulatory agency due to its status as a standard-setting organisation. The same applies to the Islamic Financial Services Board (IFSB).

The author believes that the establishment of a Supranational Authority with sanctioning powers over the conduct of IFIs is desirable and would confer greater accountability and trust on the industry. Although this change will not come overnight, it should be addressed and endorsed by the Organisation of Islamic Cooperation in its OIC-2025 action plan.

Conclusions

The Islamic model for capital financing cannot alone ensure that the morality of agents will follow from the morality of contracts, in the same way that the rules of a sport cannot prevent the occurrence of a foul. This is despite taking into account the debate among practitioners and *Shari'ah* scholars whose unprecedented input and recognised status in financial services represents an additional layer of prudential oversight for the industry, alongside regulators; one that is very positive, in light of ethical reflections on the authenticity of Islamic Finance.

Claims that Islamic Finance principles would have prevented the Global Financial Crisis of 2008 are only justified in terms of correlation. Yet correlation does not prove a direct causality and, even if it could, it has been shown that a systemic failure of this model could be triggered by the very nature of *Shari'ah* risk.

However impressive the figures on Islamic Finance assets may seem at first sight, with an estimated $2.2 trillion managed worldwide, this total does not even surpass the total assets under management (AUM) of one major global bank alone such as HSBC, which had an estimated $2.5 trillion in AUM in 2018.

The Islamic Finance industry is still relatively small compared with its Western counterpart and has yet to

prove it can represent a real alternative to mainstream finance, rather than a niche market. To do so, its business model needs to reach scales of at least 25% of global AUM, which are estimated to hit $100 trillion by 2020, according to a PWC report (PWC). Due to the practical limitations imposed by *Shari'ah*, it is hard to imagine Islamic Finance will reach such levels without compromising the integrity of its business model.

If a connection can be established that links the limited market share, size and growth of an industry or a country with greater levels of integrity in business conduct, then this paper can conclude with an open question which sounds more like a moral dilemma: should we, as Western societies, aim at lowering our growth figures to the level of Islamic Finance in order to account for better integrity, thereby giving up both the benefits and systemic risks such wealth creates? Regardless of the choice, the author believes that an answer to this question can only be reached by political means. •

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Effects of Product Complexity on Ethical Behaviour

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Finalist

Adam Morris
United Kingdom
Management Consultant,*
London (UK)

* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

"Integrity has no need of rules" – Albert Camus

The decade following the global financial crisis has been damaging for the financial services industry. Not only has revenue suffered due to the precarious position of global capital, but the industry has been dogged by ethical dilemmas that have further damaged its position. In order for the industry to rehabilitate itself over the next decade, the sector needs to answer two questions: Why is it so vulnerable to ethical issues? And what can be done about it?

This paper will argue that ethical issues seem to occur to a greater extent in financial services due to the complexity of the products it deals in. This complexity leads to a differential in knowledge between institutions and their customers, which places the former in a position of power: over their customers but also over their employees. The power of institutions to drive their employees to increase revenue creates substantial pressure to leverage the position of power they have over their customers, which in turn provides a greater opportunity for ethical dilemmas to arise..

In order to address the problem regulators, legislators and the industry need to take a more holistic and proactive position than they currently hold. By understanding how the portion of agreed knowledge, brought about by product complexity, can lead to imbalances in power, these groups can leverage a wider range of approaches, alongside existing regulation, to develop more potent initiatives against unethical behaviour. The industry as a whole

can develop solutions that are far more potent and sustainable than regulation alone can provide, by strengthening financial education for both adults and children, increasing the clarity of information about financial products and conducting deeper analysis of the factors that squeeze margins,

However, before these solutions can be developed it is essential to understand the nature of power and how the degree of agreed knowledge each party holds, due to product complexity, shapes buyer-supplier relationships.

The role of capitalism

To understand this interplay between consumer knowledge and unethical conduct, one needs to look at the central ideas of capitalism: the trade of goods and services (Wallerstien, 1975). Prices are set broadly by demand from the buyer, or the utility they attribute to an item, and the supply of this item by the seller (White, 1991). This principle creates a dialectic relationship between buyer and seller (Dampérat & Jolibert, 2009). Sellers try to achieve the highest prices for their goods, whereas buyers are trying to get the best deal (Inderst & Wey, 2007). This basic standard facilitates, in one way or another, our lives and the institutions we interact with (North, 1991). In healthy economies, where there is consumer demand, marketplaces are created with multiple vendors to facilitate provision of this service (Taylor, 2001). It is therefore in a supplier's interest to offer a competitive price because a customer can get the service from another supplier (Porter, 1979).

It is this competitive pressure, however, that forms the basis for unethical behaviour in business. A key assumption underpinning capitalism is that consumers have knowledge and oversight of the whole market, and can pick the best deal from the range of suppliers (Ratchford, 2001). Yet what happens if the consumer does not have oversight of the market or cannot understand the complex variables that make up the price of a service? Knowledge of these complexities is the unique selling point of service organisations. So how can consumers judge the best deal if they are not knowledgeable about the products? How can buyers have the ability to switch suppliers, if they are unable to differentiate effectively between products? It is this imbalance which gives financial institutions the upper hand over their customers. It creates an inequitable relationship between buyer and seller, with the power to price a good in the hands of the seller (Porter, 1979).

In order to demonstrate this notion, let us consider consumer behaviour regarding some of the simplest and most recognisable financial products: current (checking) account switching rates in the UK. If supplier and buyer power were more equitable,

we would expect to see similar switching rates to other services. Yet in 2015 only 3% of customers in the UK switched their current account, compared with 12% who switched their gas and electricity supplier (Hartfree et al., 2016). Furthermore, the argument cannot be made that banking customers are more satisfied with the service they receive. Substantial evidence shows that banking customers do not switch even when dissatisfied with their bank (Bansal et al., 2005).

The nature of the products and services that financial institutions sell means that the balance of power between supplier and buyer is skewed towards the supplier. This in turn makes it is easier to take advantage of buyers and thus create an ethical dilemma.

The balance of power

Why does this disparity in knowledge give so much licence for financial organisations to act unethically? In order to answer this question, it is imperative to investigate what is power, and how it is formed and maintained between suppliers and buyers.

The degree of complexity of a financial product has a profound impact on the relationship between financial institutions and their customers. This is because the more complex the product, the more expert knowledge is required to understand it. This mismatch in knowledge between the supplier (the financial institution) and the buyer (the consumer) has a significant impact on the degree of power each party holds. The more knowledge one party possesses, the greater its portion of power, as noted above. It is the disparity in power in the supplier-buyer relationship that increases the opportunity for unethical behaviour.

To understand this concept it is necessary to investigate notions of power. Classically, power was defined as being wielded by individuals or small groups, by way of "episodic" or "sovereign" acts of domination or coercion (Rabinow, 1991). However, this can be seen as a simple definition, only representing one manifestation of power. Classical definitions missed the power relationships that exist between individuals on a day-to-day basis. In this way, more modern discourse defines two forms of power: repressive power and normalising power (Foucault, 1980).

Repressive power

The first form of power, repressive power, incorporates traditional definitions of power. In this perspective, power is presented as a dichotomy; the capacity of an agent to impose its will on the powerless. Power is thus defined as a possession which is owned by those in power, to the detriment of those who do not possess it (Mills, 2003). For example, repressive power is evident when a judge orders a criminal to be sentenced, or a manager threatens employees to do what they are told, or be fired. In essence, it is the

suppression of an undesirable act by another agent through the use of force to get someone to do his or her bidding (Foucault, 1980). In the examples above, a judge is using repressive power to imprison a criminal for a crime, which in this case is the undesirable behaviour. Similarly, a manager is forcing his employees to do his bidding under the threat of being fired.

Two problems can be identified with using this definition of power alone. Firstly, repressive power is secondary power (Gore, 1995a). That is to say, the need to use repressive power implies a failure has already occurred; an undesirable act has already taken place. So, regarding the examples just mentioned, the state only needs to lock up criminals if its laws have been broken, and a manager who has to threaten employees is not fully in control of them. If an agent were truly powerful, then they would not have to use repressive power.

Secondly, by suggesting power is repressive intrinsically defines power as oppressive; it stops the powerless from doing what they want, bringing them in line with the wishes of those in power. This can be seen in classical interpretations of power such as Marxism, where individuals are puppets in the hands of powerful institutions (Althusser, 1984). This is an over-simplified explanation of power. As already explored, repressive power is a reaction to undesirable behaviour, which it aims to repress; yet it also enables resistant behaviour. If a state passes an unpopular law then resistant behaviour will result (Foucault, 1976). For example, when the United States passed prohibition laws in 1920, there was a boom in underground drinking dens and organised criminal activity to supply them (Lyman, 1997). This demonstrates that repressive power is inefficient because it can produce the opposite effect to its purpose. Instead of being an oppressive force, it can be a productive one.

This use of repressive power can be seen in the current approach to regulating the conduct of financial institutions. Much of the cornerstone pieces of regulation for financial services have been reactions to previous unethical behaviour; the legislation is reactive rather than proactive. A perfect example was the introduction of the US Sarbanes-Oxley Act 2002, in reaction to the collapse of Enron (Li et al., 2008). Alhough the act took great steps to outlaw the unethical behaviour seen at Enron, it did not stop it happening in the first place. This example illustrates the secondary nature of regulation; it will always lag behind those wishing to behave unethically who are not covered by particular legislation.

In addition, the introduction of further regulation elicits a response from those in financial institutions. Previously profitable activity is now inhibited, and as such, new types of

behaviour have to be found to gain a competitive advantage. Consider in his context the implementation of Basel II regulations. Banks gamified these rules, finding loopholes and attributing capital to areas where the legislation was unclear or poorly drafted (Peston, 2013). This misallocation of capital had a major effect when this capital was required during the global financial crisis. This gamification was the fate of Basel I, which required the drafting of Basel II, and in the end this was also the fate of Basel II, which required the drafting of Basel III. In its current state, legislation is inefficient at regulating the ethical behaviour of financial institutions.

Normalising power

What of the second form of power: normalising power? Foucault (1980) says that our lives are only shaped by repressive power on rare occasions. For example, only a small number of people are sent to prison. Only a small number of people within financial services engage in unethical conduct. Further to this, we do not walk around with the insatiable urge to break the law; we do not walk around a shop, for example, with only the threat of prison stopping us from shoplifting. There has to be, therefore, something more profound at play.

This is the difference between repressive and normalising power. Repressive power makes us do something we do not want to; normalising power, on the other hand, enables us to do what we want to do anyway (Gore, 1995b). Put another way, normalising power is the power that decrees what is normal behaviour or what are the social norms that we must subscribe to.

One can already see the supremacy of normalising over repressive power. Think of the public backlash when a social norm is broken. Even if an action is not illegal, there can still be a public outcry. This is evident from the backlash against unethical behaviour in finance. Often this behaviour does not contravene any laws, but the actions are held to a higher ethical standard. It is this power that Foucault identifies as normalising power, which enables people to do automatically what society desires, by codifying these desired behaviours into social norms.

Foucault thereby dismisses the idea that there is a real individual beneath the baggage of social convention; rather, without these social norms, one would not be a person at all (Foucault, 1980). Desired behaviour, in this case ethical decision-making, is an integral part of who we are as individuals. To go against this is not just to resist a select few who possess power; it is to resist the standards that the community sets. Again, this highlights the reactive nature of repressive power, which seeks to solve a problem that should not exist. In an ideal world, individuals would engage in desired behaviour because they believed it

was the right thing to do. Repressive power is in the hands of a select few; normalising power is everywhere.

If normalising power is everywhere, how are ethical issues allowed to arise? How can regulators harness this power? And how can one empower financial organisations to behave in an ethical way? In order to answer these questions, it is critical to look at the way in which relationships are formed through normalising power.

Power/Knowledge

For normalised power relationships, the level of power held by each party depends on how much agreed knowledge each party possesses (Foucault, 1980). The term "Power/Knowledge" is used to signify that power is constituted through accepted forms of knowledge, understanding and "truth":

"Truth is a thing of this world: it is produced only by virtue of multiple forms of constraint. And it induces regular effects of power. Each society has its régime of truth, its 'general politics' of truth: that is, the types of discourse which it accepts and makes function as true; the mechanisms and instances which enable one to distinguish true and false statements, the means by which each is sanctioned, the techniques and procedures accorded value in the acquisition of truth; the status of those who are charged with saying what counts as true" (Foucault, 1980, 131).

Thus, those who have more knowledge of accepted forms of truth have more power than those who have limited knowledge. One example is the power doctors have over your own body. Through their knowledge of medicine, doctors have the power to declare you fit or healthy. We therefore trade the norm of self-determination over our bodies to a doctor, based on their knowledge of medicine. Furthermore, we hold doctors to a higher standard to advise us appropriately on our health. This power, therefore, is not standalone; it is in the context of other social relationships. The power of a doctor is stronger than a random person on the street, because they have demonstrable medical knowledge.

The same is the case for the behaviour of financial institutions, which have power over managing their clients' financial risk. They hold this position because they have knowledge of the economic and mathematical levers through which this risk can be managed. In return, clients expect institutions to act in their best interests (Zacharias, 1995) and hold them to higher standards accordingly.

The problem in business occurs because employees are also tied to the norms between themselves and their employers. Employers delegate the ability to generate revenue to their staff who in turn let their employers take responsibility for their career progression and

compensation (McDowell, 1990). If this power relationship between employee and employer did not exist, then businesses would give away their products for free, as this would be the best outcome for the customer. This division of power between employer, employee and customer comes back to the dialectic nature of capitalism noted above. Ethical issues occur, therefore, when the power of the employer to generate revenue (and the reward employers bestow on employees for this generation) is greater than the power of the client to hold organisations to account.

This disparity in power comes from the knowledge of a product. An employer can hold their employees to account over reduced revenue generation. Employers often have clear oversight of the products they sell, the revenue they generate and who is generating this revenue. Businesses fail when this oversight is not present; for example, during the build-up to the global financial crisis banks loaded their balance sheets with complex derivative products which they did not fully understand (Choudhry, 2010).

In the case of the power relationship between employer and individual employees, the power sits with the employer, because they have oversight of all sales and can promote those which generate the most revenue. Put simply, employers have knowledge of overall business performance which an individual employee does not possess. This is the case in all organisations (not just financial services) where employees are empowered to behave in a way that generates as much revenue as possible. The difference comes in areas with complex products or services, as it is more difficult for customers to hold suppliers to account. In other sectors, such as grocery shopping, customers are able to compare the best deal for vegetables and hold unfair suppliers to account by shopping elsewhere. As we have already seen, this accountability is difficult to enforce even with the most vanilla financial products (Hartfree et al., 2016). Customers have limited knowledge of financial products and often have an opaque view of what represents a fair deal. Power, consequently, sits with the institution. Ethical problems thus occur when the power of revenue generation is greater than the power of customers to hold organisations to account.

This discourse is not unique to financial services; rather it is a factor which influences all ethical decision-making in organisations and is amplified by product complexity. The more complex the product, the weaker the position of the consumer compared to the supplier and so the larger the window for unethical behaviour. Consider an example from outside financial services. The pharmaceutical industry is another sector which deals in complex products and has been dogged by ethical issues – notably by raising

the price of life-saving drugs by hundreds of times (Haque, De Freitas et al., 2013). As with banking, the customer has very limited power to hold the pharmaceutical companies to account, because they are often prescribed the medicines by their doctors and depend on the drug to live. The power to generate revenue far outstrips the ability of the customer to deprive the company by switching to another supplier. As such, pharmaceutical companies have the ability to act in whatever way drives the best revenue growth, rather than in the best interests of the customer.

One can see, therefore, that the current reactive approach of regulators to tackling unethical behaviour is inefficient. The power that financial institutions hold over their customers is more profound and intrinsic than any regulation can remedy. As such, more nuanced approaches need to be taken in order to combat unethical behaviour.

A unique challenge to financial services

This holistic recognition of normalised power relationships between buyer and supplier in turn produces a unique challenge for financial services. How can the balance of power be redressed between financial institutions and their customers if the products and services that are sold are inherently complex (Howcroft et al., 2012)? Financial services differentiate themselves based on the complexity of managing financial risk. As already highlighted, the problem occurs because of the dialectic relationship that exists at the heart of capitalism. An abstract way of solving the problem would be to solve this contradiction within capitalism. This is the solution reached by many 19th and 20th century ideologies; that capitalism is inherently flawed, and as such, a new basis for social institutions has to be found (Godelier, 1967). This is not a position which this paper accepts or seeks to engage. As mentioned, the central nature of capitalism to our institutions means the outcome of these abstract discussions have far wider social impacts (Tormey, 2012) than those of ethical decision-making in financial institutions. Financial institutions must therefore be allowed to generate revenue and differentiate their product-offering like all businesses.

How can strategies be implemented to improve ethical behaviour within financial services if abstract arguments do not efficiently redress the balance of power between financial organisations and their clients? .The answer can be found by exploring real-life examples of unethical behaviour within the sector and understanding where the gaps are present.

Examples of unethical behaviour in financial services

Two scandals in the UK show how these power relationships can turn

into ethical issues. These scandals are the mis-selling of payment protection insurance (PPI) and the mis-selling of interest rate swaps.

The PPI mis-selling scandal occurred when credit providers built high- margin, low-coverage insurance products into loans in order to increase profits. Put in context, for every £100 that insurers received on car insurance, they paid £78 in claims; for PPI, they paid out just £15 for every £100 of policy income (de Meza et al., 2007). Financial organisations were able to do this because customers were not knowledgeable about the terms of the loan agreements (De Pascalis, 2018), or what constituted good insurance. As a result, credit providers were able to add insurance with little coverage for loans, safe in the knowledge that claims would not be made against it. Credit providers abused their position of power by exploiting their knowledge of the products to generate profit for their organisation.

One can see the power relationships at play in this example. Salespeople within financial organisations were placed under great pressure to increase margins for their employers. In response, products were developed for the sole purpose of generating revenue at the expense of customers. This example demonstrates how inequity of power between customers and organisations, and employees and employers, played out in the production of unethical financial products.

In a similar way, the interest rates swap scandal took place within the capital markets divisions of global banks, when they used their knowledge of interest rate trends and the swaps market to sell unfair interest rate swaps to their business clients. Rate swaps were initially set up to protect customer loans against interest rate rises. If interest rates rose then the bank would pay the customer compensation, but if they fell then the customer was liable for the cost. Some of the world's biggest banks sold these swaps to their customers at times of falling interest rates, almost guaranteeing increased customer expense. Banks were also accused of failing to mention the "break costs" of exiting the swap should a customer wish to terminate the agreement, telling clients the protection was "zero cost". The level of compensation paid by banks' client was so heavy in some cases that businesses were forced to go out of business (Popper, 2012).

Financial organisations, in this case the banks, used their knowledge of macro-economic trends to sell one-sided products where customers had no knowledge of the market, or access to it. The lack of customer knowledge of how swaps worked - in particular, that compensation can be paid both ways - delivered guaranteed margins for the banks. Once again, it can be seen from this example how banks took advantage of their power over customers to generate profit for themselves.

Strategies to address ethical issues

Lack of customer knowledge causes a power imbalance between customer and financial organisations that can be exploited for increased profits. The social norm among these institutions is to drive for increased revenue, due to the balance of power being in their favour. What, then, are efficient strategies to address future unethical behaviour, given that regulation draws on repressive power, which we have seen is an ineffective approach?

Firstly, we need to address the fundamental knowledge differential in society, namely, a lack of knowledge of finance and economics generally. In its simplest form, this means focussing resources on improving financial education across the board. For example, it involves carving out an increased portion of the curriculum in schools for financial education in matters like how to budget, the time value of money, what is a bank and its function and what products do they sell. It also requires an increased focus in schools on economics and financial mathematics. At a higher level, more advanced education should be made available to adults about how to manage their own financial risk, including the best approaches to follow.

By increasing financial education we can address the knowledge gap between those on the inside and the outside of financial institutions. For instance, if customers had more awareness of the basic components of a swap product, they would have had a better grasp of the risks involved when their bank tries to sell them interest rate protection products. In particular, they would have been better placed to realise that what they were being sold was not “zero cost”.

Secondly, if financial institutions are serious about addressing unethical behaviour, they need to make the components of their products, and thus the related risks, easier to understand. This means not hiding risks in small print and instead bringing them to the fore of product descriptions. This would give customers knowledge of the key points of the product they are considering whether to buy, free of financial jargon, and of any potential consequences of engaging in such an arrangement, thereby balancing the scales of agreed knowledge on which normative power is based. In this context, few customers would have purchased PPI, if they had had a clear view of what was being added to their loan agreements and an understanding of what this insurance covered.

Lastly, regulators need to be more proactive in assessing and identifying which market trends are likely to cause ethical dilemmas. For example, regulators should be considering where there are high levels of product saturation, or squeezes on margins, in order to understand where organisations could be motivated to use unethical practices to hit revenue

targets. These warning signs were present with both PPI and interest rate swaps and could have been identified well before mis-selling actually took place. Regulators could have seen that falling or stagnant interest rates might provide an opportunity for investment banks to make use of one-side swap deals to boost profit margins, targeted especially at business customers, with larger loan agreements but little insight into the swaps markets.

Strategies to address unethical behaviour, therefore, are much more efficient if regulators and legislators are able to identify where there is a significant mismatch between customers and financial institutions. It is this mismatch that forms the base of normalised power relationships and provides the opportunity for unethical behaviour to occur. Efficient strategies are needed to close this gap and thus reduce the window of opportunity in which unethical behaviour can take place.

Conclusion

The complexity of financial products leads to a greater window for unethical behaviour to occur. To address unethical behaviour in financial services it is necessary to understand the normalised power relationships between institutions and their customers and between institutions and their employees. This is because normalising power enables us to behave in a way that is deemed correct by a social group.

The balance of power in these relationships is set by the amount of agreed knowledge one party has over the other. In the case of financial services, institutions hold power over their clients, who are consumers of financial products with limited knowledge of what they are buying. In this case, self-regulation through notions of supply and demand is flawed because buyers are unable to shop around in an informed manner in order to get the best deal.

Additionally, one must assess the relationship between financial institutions as employers and their individual employees. Financial institutions in this relationship exercise power over their employees to generate revenue for the organisation. As such, employees of financial institutions may be motivated to generate revenue for their organisation at the expense of their customers.

This power differential is present in all capitalist relationships between buyer and seller. The unique challenge faced by the financial services sector is that financial products are inherently complex. Without this fact, financial services would not exist in their present form, raising the question: How can all customers have a more equitable relationship with financial institutions if the products they are sold can only be fully understood with expert knowledge?

By considering the UK's PPI and interest rate swaps mis-selling scandals, one can see how financial institutions can tend to exploit their

superior knowledge of financial products to the detriment of their customers, with revenue generation prioritised over customer benefits. In the case of financial institutions, social norms tend towards increased revenue generation rather than customer welfare, based on the normalised power that institutions hold over consumers.

How can this misbalance of power be addressed? Firstly, governments and educators need to promote financial education. This can start at school with more financial and economic mathematics being included in the curriculum, and lead to more advanced education on managing risk for adults. Secondly, if financial institutions are serious about addressing unethical behaviour, they need to state clearly and simply the key components of the product and the related risks, in an easily digestible manner. Finally, regulators need to be more proactive in identifying potential problem areas, such as where high product saturation or squeezes on margins occurs.

By developing a greater understanding of the normalised power relationships at play within the provision of financial services, we can begin to acquire a better appreciation of the factors that produce unethical behaviours, and implement initiatives to combat them. •

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Voting With Your Wallet

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Finalist

Mikael Homanen
Finland
PhD Candidate,
*Cass Business School *,*
London (UK)

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

People Can Make a Difference

The Dakota Access Pipeline (DAPL) protests were one of the longest protests in recent US history. They began in early 2016 in reaction to an approved oil pipeline project in the northern United States. The pipeline, more than 1,800 km long, begins in the Bakken shale oil fields in northwest North Dakota and continues through South Dakota and Iowa, ending in Illinois. It sparked controversy among environmental activists across the US and Native Americans, because the pipeline was intended to cross both the Missouri and Mississippi Rivers and ancient burial grounds.

Interestingly, it was not just the oil companies that experienced a major public backlash, but this time, the financiers suffered as well. In total, 17 major national and international banks were publicly identified as directly having financed the construction of the DAPL. These included major well-known banks such as *Wells Fargo*, *BNP Paribas*, *SunTrust*, *Mizuho Bank*, *Citibank*, *TD Bank* and *Bayern LB*, among others. By February 2017, more than 700,000 people had signed one of six petitions addressed to the banks that financed the pipeline. Individuals who signed the petitions collectively reported having more than $2.3 billion invested in these banks through checking, mortgage, and credit card accounts. They threatened to divest their wealth and cut ties, if the banks continued financing DAPL. By then, thousands had already closed their accounts (BankTrack, 2017b). Major bank protests took

place across the world. In certain cases, individuals handcuffed themselves to bank branches, forcing them to close for the day. In others, hundreds of people came together in rural communities by protesting at multiple bank branches at the same time. In some cases, protesters climbed up to the top of a football stadium, namely *U.S. Bank Stadium*, during a live football game and hung large banners demanding that *U.S. Bank* divested from the pipeline. Other high-profile events followed suit, some of which even took place during the Superbowl.

Ultimately, the full consequences of these protests are hard to establish, but recent studies have shown that these banks lost between $8-20 billion in deposits as a result of this specific movement, which has so far shown no signs of stopping (Homanen, 2018). Protests are taking place all over the world, including Canada, Australia and the UK.

Overall, the movement has shown that people have begun voting with their wallet, and are thereby, taking back control of their finances.

Did The Protests Work?

The exact cost of the DAPL movement to the targeted banks is hard to calculated, because it involves a variety of channels, such as lost deposits, loss of morale, brand value and more. However, it is very likely that these actions and associated reputational costs had a significant effect on the involved international banks and their subsequent behavior. As an example, many banks were quick to make statements in reaction to the scandal and began publicly re-evaluating their commitments to the project. By March 2017, a major Dutch international bank, namely *ING*, sold its stake to the DAPL loan. Soon after, some banks from Norway and France sold their stakes. As time went on, municipal authorities began reacting as well. These included Seattle, Los Angeles and San Francisco, which began divesting their capital from the affiliated banks and oil companies. Furthermore, Norway's wealth fund stated its intention to drop fossil energy investments and numerous Norwegian pension funds and other Scandinavian asset managers divested from companies behind DAPL.

Overall, the consequences were global in scale, making DAPL a remarkable story that showcased the potential for people to use their personal finances to promote change. However, was it enough and can we do more?

The Problem

To this day, banks continue financing major coal and carbon-intensive projects, which undermine the Paris Agreement's aim of limiting global warming to 1.5°C above pre-industrial levels (Bank Track, 2017a). In addition, banks and other financial institutions have been identified as some of the major contributors to between $21-32 trillion of private financial wealth

that has been invested almost tax-free through more than 80 offshore secrecy jurisdictions (Henry, 2012). These financial institutions also pour billions of dollars into socially questionable and non-welfare optimizing enterprises that include everything from major tobacco companies to gun manufacturers.

It is no surprise that the public has lost its trust in the financial sector, given the extent of these widely considered undesirable activities and continuous reminders of how financial institutions were responsible for the recent financial crisis. Large corporations and financial institutions have become unimaginably large and often, it feels as if the public has no control over them. The 2011 Occupy Wall Street movement was a culmination of this sentiment and openly displayed people's frustration with the sector. To this day, people's trust in the financial sector and the overall business environment remains low. In a recent global survey, 50% of respondents considered financial companies as a "little trustworthy", "not trustworthy at all" or "untrustworthy" (Trustpilot, 2018).

What, therefore, must we do to change such perceptions? And how can we take back control of our financial markets in order to re-align them with the future we want to have?

This article proposes two key solutions: 1) **Transparency** and 2) **Regulation**. What happened during the DAPL protests was a representation of the possible. Many of today's social challenges are partially caused by the lost connection between people and their investments. In the past, people had a better awareness of their ultimate assets. People invested in local firms and local banks, which in turn invested back in the local communities. Today, people are unaware of where their money is actually located and the resulting investments that they are driving. Are your deposits financing a coal mine on top of the coral reefs in Australia? Does your financial institution invest in companies that cause deforestation in Indonesia? Perhaps. DAPL represented our natural desire to re-establish those lost connections and with them, the collective means to re-invest our finances in building a socially and environmentally desirable future.

Knowing Where Your Money Goes

How do you begin tackling socially complex undesirable behaviour? As an example, tax evasion is one of society's most problematic issues to solve, because there are almost no natural market forces that can moderate it. As an illicit practice it is extremely difficult to tackle because of many obstacles, including lack of political will, unstable regulatory coordination and the absence of positive reinforcement mechanisms. Politicians have few incentives to adopt effective legislation, while

we rarely applaud individuals or companies for paying their fair share of taxes, because it is something they should have done in the first place. The problems associated with tackling tax evasion are reminiscent of other problems in finance, such as investing in oil pipelines or private detention centres.

So what can be done? We rarely know what our banks or financial institutions are investing in. Therefore, the starting point is transparency. For many of these issues, **sunlight is the best medicine**.

The Banks

Few depositors know where their banks invest and which companies receive loans from those banks. That is why DAPL was a momentous awakening for many households, as it was the first time people could visualise in concrete terms the projects that their deposits were indirectly financing: specifically, a pipeline that they did not want. Transparency on these issues is currently rather limited, but a few notable cases exist. Rainforest Action Network publishes a "Banking on Climate Change – Fossil Fuel Finance Report Card" that documents the fossil fuel investments of some of the world's largest banks (Rainforest Action Network, 2019). A snapshot of their findings indicates that 33 of the largest global banks have financed an astounding $1.9 trillion in fossil fuels since the Paris Agreement was adopted (2016–2018). These include loans to projects on tar sands, Arctic oil and gas, ultra-deep-water oil and gas and fracked oil and gas. Such reports have created significant public awareness among investors, the public and the general banking community.

More such initiatives are needed and therefore, companies like MightyDeposits are an important next step forward. MightyDeposits is a US-based startup that utilises publicly disclosed data on banks to create awareness of the real characteristics of these institutions in local communities. Users who subscribe to the platform gain access to full information about banks beyond financial fundamentals such as balance sheets and income statements. For example, they receive information about what percentage of the bank's assets is invested in the user's local community and whether these assets are owned by particular minority groups such as African-Americans or Asian-Americans. The company reflects the continuous and increasing demand among households, which are trying to re-align their social values with the appropriate financial institutions.

This demand is a driving force behind the creation of the Global Alliance for Banking on Values, a global network of banks which are committed to advancing positive change in the banking sector and the world in general. For many of these institutions, each loan that they advance must make the world a better place and they contribute

significantly to socially relevant projects including renewable energy investments and cultural development initiatives. Without them, it is hard to imagine a world, where those investments would have been financed via existing, traditional banks.

Overall, consumers who invest in banks belonging to the Global Alliance network, are conscious of the impact their savings are making. These consumers are the reason for the existence of these new forms of socially conscious bank-based capital. Without the depositors, who put their money in these institutions, these banks would never have existed. They are a reminder that it is possible to make positive financial returns while also achieving positive societal impact. The more we push and the more transparency we demand, the better we can facilitate the movement of capital to its rightful destination.

Pensions and Mutual Funds

Banks are not the only institutions that matter in the household financial investment decision-making process. Individual investors have significant holdings in other financial products, including pension funds and mutual funds, to name a few. As with banks, there is growing awareness among retail investors in such funds about where their money is located. One notable example was the fury of New Zealanders when they discovered that their pension funds (or KiwiSavers) were financing cluster bombs and land mines. The public outrage prompted a variety of financial institutions to adopt exclusion strategies; in other words, they divested their holdings in these companies. Similar stories can be found across the world. In The Netherlands, people reacted when they found out their pensions were helping to drive the creation of a world that they did not want to retire to.

Other traditional asset managers have also received comparable public attention. BlackRock, the world's largest investment management company, with over $6.5 trillion in assets under management, has been publicly identified as the largest driver of climate destruction on the planet. As a huge asset manager, BlackRock's funds collectively hold a large proportion of the world's stocks in fossil fuel companies. This publicity and other forms of communication and transparency have raised awareness that if you invest in BlackRock's mutual funds, you are indirectly supporting these are types of companies.

Studies have further shown that when Morningstar, a global financial-services firm, began identifying funds based on their "greenness" (or fossil fuel exposure), investors began fleeing the fossil fuel intensive funds (Hartzmark & Sussman, 2018; Ceccarelli, Ramelli & Wagner, 2019). In other words, people reacted, when they were shown the full information about their investments.

Fundamentally, this is the behaviour we want to promote, whether via NGO reports or financial services firms. We need to continue demanding more information about the actual impact of our investments, whether they are deposits, pension holdings, mutual funds or other investments such as our corporate bond holdings, sovereign bond holdings and even the investments of our insurance providers. All our financial decisions have a similar context that resonates with the DAPL protests. All we have to do is demand to know where our money goes.

Tools for Retail Investors

Various initiatives and organisations around the world are trying to foster transparency within financial markets. In Australia, the Responsible Investment Association Australasia provides a range of tools for retail clients to find ethical financial advisers and socially responsible investment products. Similarly, the US Forum for Sustainable and Responsible Investment provides a useful document titled "Getting Started in Sustainable and Impact Investing – A Guide for Retail Investors". The document includes information for retail clients about how to align all areas of their financial portfolios with their social and financial aspirations (US Forum for Sustainable and Responsible Investment, 2017).

Such institutions can be found in nearly every country. Sometimes they are coordinated by investment organisations and sometimes by NGOs and charities. Overall, we need more tools like these that promote financial transparency in order to re-align capital markets with appropriate goals. Currently, we need to foster traditional market forces to increase this transparency, by becoming more active in financial markets and by demanding more from our financial providers.

Investment Stewardship

Investment stewardship is about making your financial institutions work for you. Asset managers have a fiduciary duty to represent the interests of their clients. When the client's interests change, stewardship practices such as active management should change as well. Why is this important? The reason is that the majority of global stocks are now owned by large institutional investors such as pension funds, asset managers and insurance companies, instead of being directly owned by ordinary households. Therefore, the balance of power has changed, and we need to think how to discipline markets, given the dominance of institutional investors.

Fortunately, studies have shown that institutional investors can exercise a significant influence on corporate behaviour, especially regarding environmental and social issues (Dimson, Karakaş & Li, 2015; Dyck, Lins, Roth and Wagner, 2019). Portfolio companies do in fact react when asset managers engage them

successfully on socially challenging topics. In addition, institutional investors often vote in corporate AGMs on environmentally and socially relevant topics, acting on behalf of households, their ultimate clients. There will be votes on issues such as whether specific companies should disclose methane emissions or whether they should disclose their corporate lobbying expenditure.

Surprisingly, there are substantial differences of opinion among asset managers about how to vote on these issues. Some managers always vote "yes" on questions such as whether a company should disclose its emissions or whether it should have a strategy on how to approach a so-called "2°C climate scenario" where the earth's average temperature increases by 2° Celsius. Meanwhile, other asset managers always vote "no" on the same questions. There is no obvious reason why institutions take different positions, yet that is the current reality.

As mentioned above, it is important that you know where your money is. Similarly, it is just as important to know how your asset manager is literally "managing" your assets. The relevant information is not always readily available, despite a range of disclosure laws around the world which address financial institutions' active management strategies, such as proxy voting behaviour. In an ironic twist, there is actually a chance that your investments in a socially responsible fund of the kind provided by some large asset managers might have a fund manager who votes in a completely different manner to your socially-minded expectations.

Changing Stewards

There is still a small, but growing awareness that people can have a choice on these matters, notwithstanding obstacles in the proxy voting landscape. Ceres, for example, is a sustainable nonprofit organisation which addresses these and other concerns, by publishing accessible, reader-friendly articles with titles such as "*Is Your Mutual Fund Company Taking Climate Change Seriously*" (Ceres, 2017). These useful metrics, which can also be obtained from other sources, reflect the growth of transparency regarding stewardship practices.

But do people care? The short answer is yes. In one notable case, 30,000 Americans called on Vanguard, an investment advisor with more than $5.3 trillion in assets under management, to hold companies accountable on political engagement. Vanguard is entrusted with millions of people's retirement savings and as savers, the 30,000 who joined the campaign were specifically demanding that Vanguard should actively manage their corporate portfolios in a socially desirable way. They told their pension provider to oblige portfolio companies to disclose their US political lobbying and therefore, how much money they were pouring

money into the electoral process. Vanguard was thus perceived to play an enormous role in enabling secret corporate spending in US elections.

Overall, as the demand for information and accountability grows, behaviour will ultimately change. The more we find ways to bring transparency to these practices, the faster change will come. For example, Morningstar, the financial services company mentioned above, recently acquired FundVotes, a company specialising in fund-level ESG (environmental, social and governance) proxy voting data. The acquisition implies that that sooner rather than later, we will have even greater awareness about how our funds engage with their portfolio companies.

Regulation

Support from the state is crucial. While demanding societal change from our financial institutions is important, we must also continue to demand action from our politicians; not just via direct intervention, such as introducing carbon taxation to help combat climate change, but also through indirect initiatives to facilitate the alignment of our societal interests with appropriate forms of finance.

As an example, on 13 March 2019, US Representative Alexandria Ocasio-Cortez asked Wells Fargo's CEO at a House Financial Services Committee hearing whether his bank was involved in ”caging children”, since the bank was involved in financing privately-run detention facilities. In addition, she asked, ”if there was a leak from the Dakota Access Pipeline, why shouldn't Wells Fargo pay for the cleanup of it, since it paid for the construction of the pipeline itself?”. Wells Fargo and other banks have been similarly questioned by Ocasio-Cortez for their involvement in financing gun manufacturers, thereby publicly connecting them as one of reason for rising gun violence in the US.

More is required, despite this vivid example of an elected representative voicing the specific concerns of her constituents about financial markets. The transparency that has been continuously demanded in earlier sections can be enhanced forcibly via legislation. As an example, the Technical Expert Group on Sustainable Finance at the European Commission has been set up to assist in developing the European Commission's legislative proposals on issues related to EU Green Bond Standards, EU climate benchmarks and guidance on corporate disclosure of climate-related information. Progress has already been made, but it will be just as important to enact legislation that requires investment advisors to disclose climate-specific information (and potentially, other socially relevant data) to retail investors.

The law requires fund managers to present investment opportunities to retail investors with appropriate details on risk profiles and expected

performances. While climate resolutions are sometimes politically sensitive, there is no reason why households should not have the option to invest in a green portfolio or to divest from a fossil fuel-intensive stock. Ultimately, as far as our investments go, households should be allowed to execute any decision that could be characterised as moral in nature. In this context, it is never questioned that households have an independent right to install a smart meter in their homes. Therefore, why should they not be allowed to have a smart meter for their investments? In addition to knowing their energy expenditure, people should have the right to know the fossil fuel exposures of their financial portfolios. At present, there is still no uniform regulatory mechanism that allows investors to align their societal values with their financial preferences, even though there is clearly a growing demand and appetite. Adopting legislation that would force these types of disclosures would be a significant step forward.

Central Banks

Transparency is the first step that should be demanded as far as legislation is concerned. However, our political institutions have other means of exerting influence in the real economy. For example, central banks across the world have recently joined the Network for Greening the Financial System. The group's missions include helping to strengthen "the global response required to meet the goals of the Paris Agreement and to enhance the role of the financial system to manage risks and to mobilize capital for green and low-carbon investments in the broader context of environmentally sustainable development".

As citizens, we do not have any direct channels for influencing central bank behaviour. However, it is fair for citizens to ask that their regulators be aware of rising societal risks, such as climate change, and to make sure those risks are fully accounted for. Central banks should hire environmental economists, so that they can better forecast rising risks due to natural disasters and other climate-related risks that can have massive implications for our economies and financial stability. For example, in the UK, leading academics and representatives of civil society have publicly demanded that the next Governor of the Bank of England (the UK's central bank) should commit to serving the whole of society, and not just financial markets. This is another illustration of how people are demanding change from their financial institutions, including their central banks.

Conclusion

The DAPL protests would have happened anyway. People come together and act when their communities and livelihoods are threatened, people come together. But was it obvious that the banks would be targeted as well? No.

Information was difficult to find. Publicly accessible data on corporate-level financing was only available through very specific corporate filings, and finding those documents required knowledge that they existed in the first place. In addition, those filings did not include the actual details about bank-level project financing. They were only available through an expensive financial data subscription, which required cross-continental collaboration among specific NGOs (Cook and MacMillan, 2019).

Transparency was essential to the story. The information about bank financing was made accessible to everyone through media, NGO campaigns, blogs, protests and journalistic reporting. First, the corporate-level financing was disclosed and afterwards, project-level financing information became available as well. This information spread beyond Indigenous digital media communication to the mainstream media after a notorious case was broadcast showing footage of private security guard dogs biting Native Americans at Standing Rock. From then onwards, other crucial bank-level financing infographics were widely circulated amid the ongoing onsite violence: for example, the DAPL finance graphic released by Food & Water Watch. Once this information reached the wider public through a series of specific events, people worldwide felt they were involved – many of them through the bank cards in their wallets.

Today, we have many means to spread information, but surprisingly few opportunities to find it. As individuals, we need to demand more from our financial institutions and continuously remind them to disclose socially relevant information. Financial institutions need their capital providers, meaning you, the ordinary householder. If you leave them, they lose your business, ultimately forcing them to react. The resulting market force creates momentum towards positive change. To grease the wheels, we need updated legislation to continue our collective push towards a better, sustainable and ethical future. •

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Unethical Behavior of Financial Influencers

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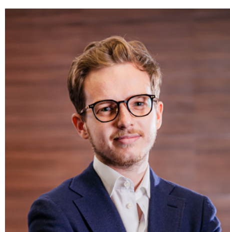

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"Integrity is doing the right thing, even when no one is watching" – C.S. Lewis

Introduction

High yields, secret techniques, best trading signals: the abundance of marketing slogans invented by self-appointed trading experts is impressive. Sometimes for free, and more frequently for a fee, these people are willing to share their knowledge and market insights with individual investors. The fast-growing interest in investing in the cryptocurrency market and the turbulent events since 2020 have produced dozens of informal investment advisers who now form an entire industry. Bleak economic outlooks, subsequent lockdowns and more time spent online, as well as the stock market bounce-back after the pandemic low in early 2020, have created more interest in trading among new, usually young and inexperienced investors.

This new generation of market participants often lack appropriate knowledge and no longer scan classic finance books for information; nor do they seek advice from professional capital market players. Hungry for easy recipes for profit-making, they follow online channels and the websites of stock market experts who describe trading fluctuations in plain language. These experts are generally referred to as financial influencers or "fininfluencers". Just like traditional market influencers, they can exert a significant influence on the actions of their audience by discussing market developments and sharing opinions - actually indirect investment recommendations – about financial instruments.

The activity of fininfluencers is on the verge of becoming an informal and barely regulated domain. In many jurisdictions, including the EU, investment recommendations and advice can only be offered by licensed investment firms. However, there are various loopholes that individual investors discuss on a wide range of online groups and forums. Strong opinions shared online have the potential to overlap with the sphere of investment recommendations. These legal loopholes are exploited by fininfluencers who can be likened to professional consultants, given the scale of their activity and authority-building techniques.

The nature and scale of fininfluencers' authority enables them to earn extremely high fees for their opinions while at the same time exposing the capital of their audience to risk by using it as a tool for manipulating stock exchange movements. Worse, the absence of legal controls makes it impossible to vet this type of market expert, with financial regulators worldwide only just starting to become aware of this substantial new area of risk.

Currently, there is no ethical discussion about threats that may arise from the unregulated activities of informal investment advisers who cannot be held to account. Nor have any broader analyses and studies of the problem been undertaken. This paper aims to spark a debate about ethical threats relating to the activities of fininfluencers and how their work may be regulated legally.

Old methods, new scale

The Latin phrase *nihil novi sub sole* (nothing new under the Sun) applies very well to financial influencers. At first glance, their business model may resemble an innovative mix of investment consulting and social marketing. In fact, however, the beginnings of the industry go back to the second half of the 20th century and the advent of so-called trading gurus in the US. They were usually market analysts who, having taken advantage of favourable circumstances which proved their point, gained the attention of the trading public. These experts would publish paid-for stock exchange bulletins with analyses, advice, and transaction recommendations.

The digital revolution opened up new possibilities for gurus to influence the trading environment. Previously their reach was naturally limited to a group of paper bulletin readers, but today's fininfluencers can even inspire stock market transactions in real time. Guided by the opinion of their trading authority, the audience engages in transactions involving a specific asset *en masse*, thus generating excessive movement and volatility.

The fundamental difference between contemporary financial influencers and old-school trading gurus is thus the scale of their impact and the speed with which they can reach their followers. Aware of the existence of this group of market

experts, the European Commission adopted a regulation in 2016 which states that an "'expert' means a person referred...who repeatedly proposes investment decisions in respect of financial instruments and who:

- presents himself as having financial expertise or experience; or
- puts forward his recommendation in such a way that other persons would reasonably believe he has financial expertise or experience" (Commission Delegated Regulation (EU) 2016/958, 9 March 2016).

This EU regulation appears to regard as irrelevant whether a specific recipient accepts a fininfluencer's statement as the recommendation of a market expert. What matters is how the message could be received by the average person. Given the EU's approach, and the behavior of contemporary financial market gurus described above, the following definition can be proposed:

Financial influencer (fininfluencer): a person who, in the opinion of an average recipient, appears to be an expert in the area of financial markets, repeatedly providing direct or indirect opinions, analysis and/or investment recommendations or guidance, in particular via electronic communication including text messages and voice or video recordings. Through his or her statements, a fininfluencer can influence the recipient's investment decisions, which en masse may affect the prices of financial assets. This person does not have to possess a formal qualification or specialist knowledge in the field of economics and finance, or possess an appropriate professional license. However, they are perceived as having experience and expertise in how financial markets operate.

A leap in popularity

The fininfluencer industry recorded particularly dynamic growth during the COVID-19 epidemic at the beginning of the 2020s. Over that period, there was a dramatic rise in interest in online experts explaining the most recent and disruptive developments in stock markets. A quick look at some selected top fininfluencers' reach is given in Table 1 below. Some argue that this leap in popularity was only the tip of a wave that had started earlier. A market review shows that experts discussing the most polarizing economic problems, as well as personal finance, financial education, and current events from a broader perspective, were attracting the broadest audiences.

The market for individual trading experts has expanded in particular in India, perhaps due to the size of the population and the fact that society is growing wealthier, fueling investment; and in the US, where lively public interest in investment has existed for decades. This online reach indicates the unprecedented scale of influence of today's stock market experts.

Table 1. Approximate audience reached by selected leading fininfluencers

Name of influencer/ channel	Language	Primary communication platform	Approximate audience size (subscribers/ followers in million)
Erika Kullberg	English	TikTok	9.1
Pranjal Kamra	Hindi (English subtitles)	YouTube	5.0
CA Rachana Phadke Ranade	English	YouTube	4.3
Labour Law Advisor	Hindi (English subtitles)	YouTube	4.0
Asset Yogi	Hindi (English subtitles)	YouTube	3.6
Humphreytalks	English	TikTok	3.3
Tatlondono	English	TikTok	2.8
Warikoo	Hindi (English subtitles)	YouTube	2.7
Herfirst100k	English	TikTok	2.2
Invest Aaj For Kal	Hindi	YouTube	2.1

Source: Own study, 11 February 2023

One of us

A typical market guru or fininfluencer may present themselves as a market outsider: he or she thinks outside the box, often in sharp opposition to the existing consensus, sharing non-standard opinions. At a time when there is widespread distrust of authorities and institutions, such an image of an expert is likely to capture attention. The expert is regarded as "one of us," someone who finally speaks the bitter truth out loud. What is more, the growing number of new followers who trust the expert's recommendations may create the effect of a self-fulfilling prophecy: the guru's investment recommendation can trigger an avalanche of stock market decisions by followers which, in turn, may create the impression that the expert has measured the market mood perfectly.

However, this feature – the temporary accuracy of forecasts - is only one side of the coin. It should be kept in mind that new, inexperienced individual investors may feel lost when confronted by the chaos of financial markets. Some of them may succumb to the allure of a leading authority who offers a sense of community and a shared vision or interpretation of current events. By supplying ready-made signals and transaction strategies, fininfluencers also give simple answers to

complicated questions regarding the nature of the stock market, thereby creating the illusion that profitable trading is easy. Ultimately, by relying on the expert's recommendations, the investor ducks the responsibility for wrong decisions, thus alleviating the unpleasant feeling of cognitive dissonance. Instead, the errors are seen as his or her fault, not mine.

Omnichannel recommendations

Fininfluencers share their insights and recommendations in the public domain, which is freely available to a wide audience – for example, through YouTube videos. However, they often also offer the purchase of a subscription to their privileged content. In this way, they appear to form an exclusive club of users, which builds a sense of belonging to an elite group and access to secret knowledge. These experts, whether through open access or within a closed group, may share their recommendations in a slightly more formalized text form, which may be exposed to more stringent legal restrictions and the risk of verifying the results, or directly through shared podcasts or videos. The accountability of a guru who offers his or her recommendations through recordings is lower .

Fininfluencers often directly say what investment decisions they intend to make or what assets they have in their portfolio, which is frequently an indirect invitation to imitate them. Individuals unfamiliar with the stock market can therefore go for the "reliable" tip of their trusted expert. Those fininfluencers who produce extensive and frequent content may also expect that their recipients will forget what was said before, which further bolsters the expert's image as an infallible oracle who "said it would be so," without explaining exactly when and what they predicted.

Bot advisers

It would seem that the obvious competitors for fininfluencers are professional investment advisers and investment firms. In fact, however, the 2020s have seen the emergence of a new type of market player: a virtual investment adviser powered by artificial intelligence (AI). Relying on an in-depth analysis of market data and knowledge of the investment goals and profiles of their clients, algorithms can recommend proper transaction strategies, advise on preferred investment portfolios, and even steer capital management unattended. Removing the human factor from financial advisory does not, however, diminish the scale of ethical dilemmas; on the contrary, it opens up new avenues that still need to be properly addressed.

Nobody knows how an AI adviser, powered by the content of the network, will behave, and what goals and ways to achieve them it will follow. Certainly, it can be assumed that the AI adviser will be as ethical as its creator. The problem, however, is the "liberation" of its

algorithms so that the virtual adviser is able to make its own, unprompted decisions. This would be like giving algorithms "free rein," which is already occurring to an increasing extent in financial markets through so-called algorithmic trading. However, these algorithms can also be cloaked as humans which whom you can interact. This has become possible thanks to the so-called *Large Language Models* (LLMs), artificial neural networks which can learn independently and communicate with people (ChatGPT). By combining LLMs technologies, trading databases, and powerful analytical resources, an almost perfect investment adviser or fininfluencer can be molded.

Incredible as it may seem, it is not difficult to picture a situation in which a specific fininfluencer turns out to be an algorithm. A warm and empathetic person who builds bonds and trust among his or her audience through entries and recordings could turn out to be a cold machine pursuing the goals of its maker - for example, by manipulating investors' behavior. This scenario is not as unlikely as it may seem, given the progress of real-time voice and facial expression simulation technology. There are already virtual influencers (CGI influencers) which have won social media following (Hiort, 2023). Who would ultimately be held accountable for the actions of an artificial fininfluencer remains an open question. Another issue is whether such a "*persona*" would be licensed to issue any investment recommendations at all.

Black economy

It is commonly held that trading recommendations must appear to be sourced from licensed investment companies. Investment recommendations primarily fall under provisions that are uniform for the entire EU and are contained in *Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014*. Specific requirements for investment recommendations are included in *Commission Delegated Regulation (EU) 2016/958 of 9 March 2016*. The said regulations provide that recommendations that are not regarded as investment advice are legally admissible. However, they go with information obligations regarding their preparation methodology (the basis for issuing), as well as being required to meet the conditions of objectivity and reliability.

If these criteria are met, fininfluencers are also entitled to offer investment recommendations. The regulations clearly stress the need for such recommendations to be transparent. However, even if due diligence is observed, fininfluencers often operate on the verge of investment advice, which in their case should be considered illegal, as it is only mandated to be offered by licensed institutional entities. In Poland, in accordance with the current wording of *Article 76(1)*

of the Act on Trading in Financial Instruments, "investment advice involves the preparation, initiated by the investment firm or requested by the client, and transfer to the client...of a recommendation issued in response to the client's needs and condition, regarding the purchase or sale..., or other action producing similar effects, the subject of which are financial instruments, or a recommendation to refrain from performing such an action" (*Act on Trading in Financial Instruments*).

These provisions directly govern the communication model used by fininfluencers, whose investment recommendations are addressed to the general public. Consequently, their advice is on the safe side. They do not know the identity of the recipient of the message or the individual's plans or personal situation. For this reason, fininfluencers' words are not considered a personal recommendation. Fininfluencers knowingly avoid private conversations, although they may answer anonymous questions that do not pertain to the situation of a specific person during communications that are intended for unspecified recipients. In this way, they are still able to take specific questions from specific recipients.

Greed

Regardless of the legal framework governing the activities of informal investment advisers, legislators and supervisory bodies are only just beginning to identify serious ethical problems that may be linked to the operation of fininfluencers, even including fraud. A fininfluencer has a measurable market advantage over his or her audience. Using their position and earned trust, they can shape their followers' moods and beliefs and, consequently, their behaviour. They profit from the asset price fluctuations that the recipients generate. When issuing recommendations, fininfluencers invariably face the temptation to resort to abuse, with the temptation even greater if the community of followers is particularly large.

The basic methodology may involve the fininfluencer stimulating upward trends, having previously acquired specific assets. In other words, a fininfluencer first purchases a specific asset, and then, having notified their audience about this fact (if he or she is honest) or not (if not), they start exerting pressure on their recipients to purchase the asset. For example, they may post positive opinions about the relevant company or directly point to the rationale for holding its stock. Tempted by the recommendation of their authority, the recipients go shopping, thus generating trading demand which increases the price of the asset. Once the price has gone up, the fininfluencer can reap profits, only to admit later that they sold the instruments "some time ago."

The option of concluding undisclosed and informal agreements under which the fininfluencer's

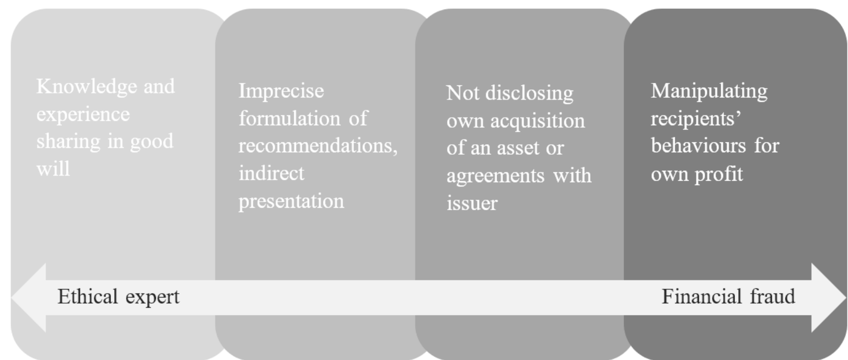
investment recommendations are controlled by third parties must also not be ruled out. This can be likened to undisclosed investment advice provided in a dependent manner - for example, related to the issuer of the instrument. The grayscale of unethical behavior by fininfluencers is illustrated in Figure 1 below.

In the bigger picture, certain experts' opinions can be clearly linked to changes in asset prices. Research data concerning this area, however, is far from conclusive. On the one hand, there is analysis of so-called market sentiment which focuses on the potential correspondence between investors' comments over a given period of time and the rate of return. However, these comments are studied holistically. Studies addressing the impact of individual fininfluencers on stock prices are few. Attempts have been made to employ machine learning algorithms for this purpose, yet they struggle with significant information noise, which makes it difficult to obtain reliable results (Doğan *et. al.*, 2020).

Growing regulatory interest

The risk of fraud and adverse influence are increasingly a focus of attention for supervisory bodies. A significant rise in regulatory interest in fininfluencers was witnessed in 2022, although the intensity of response varied around the world. In Poland, the Polish Financial Supervision Authority (KNF) issued a communication aiming to discourage investors from following the advice of fininfluencers and published a list of alarms that may indicate a lack of integrity in an expert. The KNF has also registered legal doubts, mainly related to investment advice, around such an expert's activity (*Komisja Nadzoru Finansowego*, 2022). Earlier, in 2021, a similar warning was issued by the European Securities and Markets Authority

Figure 1. The grayscale of fininfluencers' behavior



Source: Own study, 11 February 2023

(ESMA), focusing primarily on legal obligations attached to the issuing of investment recommendations (The European Securities and Markets Authority, 2021). At the beginning of 2023, the ESMA announced a project designed to verify the compliance of marketing communications of investment companies with MiFID II regulations. Significantly, this project includes cooperation with influencers (The European Securities and Markets Authority, 2023).

In late 2022, the US Securities and Exchange Commission (SEC) accused eight fininfluencers of manipulating stock prices by influencing investors via social media. The scale of the fraud was estimated $100mn (U.S. Securities and Exchange Commission, 2022). Meanwhile, the first criminal cases were also brought in Australia (Australian Securities & Investments Commission, 2022a). The local Australian Securities & Investments Commission (ASIC) issued a clear warning that the provision of financial services without a license is punishable by a prison sentence of up to five years (Australian Securities & Investments Commission, 2022b). The Australian media reported that following the ASIC's campaign, there was an exodus of fininfluencers, with many completely abandoning their activities (Dean, 2022).

India's market is particularly interesting because the fininfluencer community has grown rapidly in recent years, to the point where specialized influencer marketing agencies have been established to offer services to the industry (Roy, 2022). India has not only seen a significant increase in unregistered investment adviser businesses, but also cases of listed companies hiring fininfluencers to push up asset prices. In response, the Securities and Exchange Board of India (Sebi) started developing guidelines for fininfluencers at the end of 2022 (ENS Economic Bureau, 2022).

Specific ways to hide in the shadows

Despite the efforts of regulators, the ethically dubious activities discussed above are not easy to spot in the market, especially when the value of transactions is relatively limited. In the case of the stock market, it is theoretically possible to validate the behavior of certain entities through central counterparties such as the National Depository for Securities in Poland, which have access to relevant data. However, speculation carried out through *over-the-counter* (OTC) *derivatives* remains largely beyond control. Particularly interesting are the options supplied with *Contracts for Difference* (CFD), which are even offered by licensed broker firms. A CFD is a *derivative financial instrument* of the *OTC market*, and its price is linked to changes in a specific underlying instrument. What is more, it permits the use of financial leverage, thus potentially boosting the profits of a dishonest fininfluencer.

Only the offering broker is responsible for the organization and settlement of CFDs. Transactions in these instruments do not correspond to actual orders in the underlying instrument on the stock market. Consequently, market transparency is reduced and certain transactions can remain covert, especially in the case of brokers not covered by the supervision of domestic or EU regulatory bodies. CFDs also enable the short selling of financial instruments, meaning that profits can be earned from falling asset prices (Kurzajewski & Nowalińska, 2017). Thus, fininfluencers acquire a tool to profit from deliberately pushing the price of a financial instrument downwards.

It is worth noting that some brokers which offer CFDs contribute to expanding the fininfluencers' impact. This occurs when brokers offer automatic duplication of investment decisions by a selected expert in real time, as in the case of eToro's *Copytrader* system (eToro, n.d.). In effect, this approach bypasses the expert's lack of a license to manage investment portfolios, such licenses being usually intended only for investment companies. Therefore, there is a significant set of ethical and legal doubts regarding the operation of fininfluencers.

First aid in trading

The simplest solutions that might help regulate the industry would most likely lead directly to excessive tightening, due to the temptation to prohibit non-professional entities completely from issuing investment recommendations. However, the first question is whether the industry should be regulated anyway. In fact, fininfluencers can fill a very important gap regarding insufficient investor education and the promotion of informed investing. At its best, their work raises social awareness and enhances the knowledge of investors themselves. Thus, through education and sharing, they have the potential to be responsible opinion leaders rather than trading miracle-mongers.

What is more, they can help their audience navigate simple issues relating to investments. Keeping this in mind, their activity can be likened to *paralegal* services (legal advisers with enough competence to solve simple legal issues, but without full qualification and professional license to act as legal advisers). On the other hand, even where quasi-professional experts act in good faith, the existence of fininfluencers who directly encourage risk-ridden speculation cannot be ruled out. If this market is left alone, it will most likely create room for a fininfluencer underworld. There are at least several regulatory roadmaps for tackling this problem.

Adviser rather than influencer?

In some jurisdictions such as Poland, the profession of investment adviser is regulated. Such a career can only be pursued by people who

are registered with the financial market supervision authority. To be admitted to the list, the applicant must fulfil certain conditions and, above all, demonstrate knowledge and competence during professional examinations, adhere to ethical standards, and hold a relevant professional qualification such as *Chartered Financial Analyst* (CFA). In Poland, only investment advisers under the supervision of the KNF are authorized to provide investment advice.

The professional title of investment adviser, as in the case of a CFA and other related capital market certifications, is the gold standard for qualification and reliable proof of an individual's credentials. Such certified individuals earn further trust by being under the supervision of inspection bodies and subject to severe penalties for violating professional ethics, including the loss of their professional registration. In Poland, however, some groups advocate that the profession of investment adviser be deregulated and equated with financial advisers who do not have to demonstrate any proof of qualification (Kolany, 2015).

It seems that the tedious process of acquiring a license, where candidates have to learn a large body of comprehensive knowledge, and the regulated nature of the investment adviser profession, may themselves reduce the problem of quasi-advisers and dispel the related ethical doubts. Nonetheless, the powers associated with this profession should be extended, so that advisers can provide investment advice on his or her own account. In Poland, the current legal context only enables investment advisers to offer investment advice services if they have an employment relationship with an investment company (*cf.* Article 125 of the Act on Trading in Financial Instruments). In practice, licensed advisers cannot work in the profession if they are not employed in a position related to investment advice, and only the license can pave the way to promotion within the financial industry.

Conclusion

As private analysts of financial markets, fininfluencers enjoy a significant market edge as they can steer the behavior of their audiences. These are mostly individual investors who, following the recommendations of influencers they regard as respected authorities, may conduct transactions *en masse*, thus influencing the price of a specific financial instrument. This creates broad opportunities for fininfluencers to exploit their position in order to reap profits from trading speculations unethically, sometimes even by deceiving their audience.

Attempts to regulate the activities of modern finance gurus seem desperate but are necessary. For this purpose, professions already existing in some jurisdictions

can be used - for example, that of investment adviser in Poland - with their powers extended to cover individual investment advice. An alternative road is to develop a quasi-professional qualification intended for fininfluencers which would at least oblige them to become familiar with the legal and ethical requirements governing investment recommendations. Another forward-looking step would be to oblige trading experts to register with financial market supervision bodies which would regulate them.

This supervision, however, might become an issue if it adopts an outdated and conservative model which fails to keep pace with the dynamics of today's stock market speculators. In practice, it seems difficult to enforce reporting obligations concerning concluded transactions based on recommendations issued by fininfluencers. Still, full transparency of issued recommendations should be enforced. These should be accompanied with clear information on whether the individual making the recommendation has carried out or plans to execute transactions on the recommended asset before their issue, regardless of the type of financial instrument used (including derivatives) and the value of the commitment.

Recommendations

The need for multi-pronged intervention is self-evident, aimed at regulating the industry and above all, at making it more ethical. It seems unquestionable that a code of ethics and a code of good practice for fininfluencers should be developed, forming an ethical framework for the industry, as exists for Polish brokers, investment advisors (*Zasady Etyki Zawodowej Maklerów i Doradców*, n.d.) and brokerage firms (*Kodeks Dobrej Praktyki Domów Maklerskich*, n.d.). At the same time, one must not ignore the role of AI, whose application is becoming more and more visible in financial markets, including in investment advice. A policy of full transparency in issued investment recommendations should be encouraged, regardless of whether they have been issued by a human or generated by an AI-enabled advisory tool.

Bottom-up establishment of the code would represent self-regulation by the industry, sending an important message of good faith by at least some fininfluencers. Such an initiative would certainly be received positively by market legislators and regulators. It would also accelerate the professionalization of the industry and bolster its image. At some point, however, market regulators would need to approach fininfluencers for a "check", as is the case in Australia. If these experts are not prepared for such a moment of truth, they may be confronted by a lack of sympathy on the part of regulators, leading to further caps on their operations and even prosecution if they fail to take appropriate steps to lay a strong ethical foundation for their activities.

Lastly, legislators and regulators should be aware that they should not always equate fraud with fininfluencers. There are many ethical trading professionals who, despite their lack of formal professional qualification, boast extensive experience and expertise that can help promote prudent investment decisions by the public at large and educate investors. This aspect is particularly important in jurisdictions in which interest in and knowledge about investing remains relatively low. At this stage, cooperation with such opinion leaders is worth considering.

An antagonistic approach to fininfluencers should therefore be replaced by a spirit of cooperation based on real collaboration opportunities. In this spirit, some fininfluencers might voluntarily submit themselves to supervision and adopt the industry's ethical standards to demonstrate their good intentions. Certainly, financial influencers should not in principle be seen as a problem to be combated; instead, more attention should be paid to eradicating market pathologies which, if left unattended, will sooner or later create space for underhand dealings. The author hopes that the adoption of ethical standards by fininfluencers will make it possible to separate the bad from the good in future and support the promotion of ethical behavior among trading advisers.•

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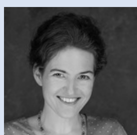
Appendices

The Global Prize Jury
7th, 8th and 9th edition



Dorothea Baur is an expert with many years of international and interdisciplinary experience in the field of responsibility, sustainability and ethics. In her role as an independent consultant, Dorothea Baur advises companies, pension funds, foundations and NGOs on issues related to sustainable investments (ESG), artificial intelligence and ethics, as well as corporate social responsibility (CSR) and sustainability. Dorothea Baur studied Business Administration and International Relations in Zurich, Leuven (BE) and St. Gallen (CH) and received her PhD on NGO-Business partnerships from the Institute of Business Ethics at the University of St. Gallen. Afterwards she taught and researched at leading European business schools (e.g. ESADE Barcelona, Nottingham University Business School). From 2017 to 2020, Dorothea Baur was the independent ethics officer of Alternative Bank Switzerland. She continues to teach at various universities and universities of applied sciences.

Jury member: 7th to 8th edition of the global Prize

Stéphane Bernard, is Chief Operating Officer at Euroclear Bank, a member of the Management Committee and Executive Board Member. Stéphane Bernard also heads Asset Servicing & Transaction Operations at Euroclear Bank since April 2012. In 2017, Stéphane was appointed CEO of the Euroclear Bank Poland Branch. Prior to taking his current position, Stéphane was a member of the Euroclear Bank Management Committee Advisory Group. He was an ESES Audit Committee member and also a member of the Board of Directors of the ESES central securities depositories (Euroclear Belgium, Euroclear France and Euroclear Nederland) till December 2018. Mr Bernard was COO for the ESES CSDs as well as being and part of its management committee until April 2012. Before this, Mr Bernard was Chief Executive Officer of Euroclear Belgium (formerly CIK SA/NV). He was General Manager of Belgian central securities depository, from 2001 until 2006, when CIK joined the Euroclear group. Earlier in his career, Mr Bernard headed the Operations department at Delta Lloyd Securities, where he managed challenges such as the euro transition, Y2K and capital infrastructure consolidation resulting from the creation of Euronext. Mr Bernard started his career with a broker dealer in 1989. Mr Bernard holds degrees in Commercial and Consular Sciences from the Saint Louis Institute of Commerce in Belgium, a degree in Marketing from Institut Supérieur Economique Ixelles and a Masters in Treasury Management from the University Antwerp Management School.

Jury member: 6th to 9th edition of the global Prize

Pascal Cescom is the Chief Ethics Officer of the Banque de France, reporting to the Governor. He is in charge of designing and controlling internal ethics rules, promoting ethics awareness and culture, advising the Governor, the managers and the staff. He represents the Banque de France in the Ethics and Compliance Officers Task Force of the central banks and supervisory authorities of the Eurosystem. He is member of the Cercle d'Ethique des Affaires, the French association for business ethics. Pascal was previously Labour Relations Director of the Banque de France and Chairman of its Health & Safety Committee in Paris. He negotiated collective agreements in particular on social dialogue, psychosocial risks, gender equality and telework. He succeeded in increasing threefold the Banque de France staff seconded to the European Central Bank when the European Single Supervisory Mechanism was set up. Pascal holds a Master's degree in Public Organizations and Policies Analysis from Sorbonne University and graduated in Public Affairs from Sciences Po Paris.

Jury member: 7th to 8th edition of the global Prize

Prof. **Marc Chesney** is Professor of Finance at the University of Zurich. Previously in Paris, he was Professor and Associate Dean at HEC, President of the CEBC (Centre d'Etudes sur le Blanchiment et la Corruption) and an external expert with the World Bank. He has published articles and books in the areas of quantitative Finance and also of financial crime mechanisms. In addition, he focuses on the subject of Ethics and Finance. At the University of Zurich, he is member of the Board of the Graduate Programme for interdisciplinary Research in Ethics and co-organizer of the Ethical Finance Research Series. He is also member of the advisory Board of Finance & Common Good/Bien Commun. Marc Chesney holds a Ph.D. in Finance from the University of Geneva and obtained his Habilitation from the Sorbonne University.

Jury member: 1st to 8th edition of the global Prize

Prof. **Henri-Claude de Bettignies,** the Aviva Chair Emeritus Professor of Leadership and Responsibility (INSEAD) is also the Distinguished Emeritus Professor of Globally Responsible Leadership at the China Europe International Business School (CEIBS) and former Director of the Euro-China Centre for Leadership and Responsibility (ECCLAR) that he created in Shanghai, at CEIBS, in 2006. Between 1988 and 2005, and again since 2013 he has a joint appointment at Stanford University (Graduate School of Business), and he shared his time equally between Europe, California and the Asia Pacific region. Among the 8 books published under his name are: Business Transformation in China (Thompson Business Press, 1996), Le Japon (Flammarion, 1998), Business Ethics: Policies and Persons (McGraw Hill, 2005), and (with F. Lepineux) Business, globalization and the Common Good (Peter Lang, Oxford, 2009) and Finance for a better world: the shift toward sustainability (Palgrave, 2009) and more recently Puissance et Responsabilité: où en est la Chine? (Gulbenkian, 2014) and (with M. Thompson) Leadership, Spirituality and the Common Good (Garant, 2010).

Jury member: 1st to 4th and 7th to 9th edition of the global Prize

Mr **Christopher de Mattos** is a non-executive director and is on the advisory board member of several companies, including London-based investment firm RAB Capital Ltd. He has spent over 30 years in the financial services industry, working as a financial analyst and investment banker in Europe and Latin America as well as in investment management. Christopher joined the founding team at RAB in 1999 and, as Finance Director, was instrumental in taking the company to flotation on London's AIM market in 2004. He holds a degree in Mechanical Engineering from Imperial College, London and an MBA and Certificate in Corporate Governance from INSEAD. He has taken a particular interest in the role of the board in promoting corporate governance, is an INSEAD Certified Director and past chair of the INSEAD Directors' Network. Christopher is also a trustee of the Lord Kitchener National Memorial Fund and a member of the Imperial College Court.

Jury member: 3rd to 9th edition of the global Prize

Prof. **Paul H. Dembinski** is the initiator and Director of the Foundation of the Observatoire de la Finance in 1996. The mission of the Observatoire de la Finance is to promote awareness of ethical concerns in financial activities and the financial sector. Paul H. Dembinski is the founder and editor of the quarterly bilingual journal entitled Finance & the Common Good/Bien Commun. In parallel, he is partner and co-founder (with Alain Schoenenberger) of Eco'Diagnostic, an independent economic research institute working for both government and private clients in Switzerland and elsewhere. Paul H. Dembinski is also Professor at University of Fribourg (Switzerland) where he holds the chair of "International Competition and Strategy". In 2019, he has been awarded a Doctorate honoris causa by the SGH-Warsaw School of Economics. Latest published book: Ethics and Responsibility in Finance, Paul H. Dembinski , Routledge, 2017.

Co-chair: 1st to 9th edition of the global Prize
Vice Chairman: 1st to 7th edition of the Polish Prize

Dr **Eduard Dommen** is a specialist in economic ethics. He is past President of the Scientific Committee of the Geneva International Academic Network (www.ruig-gian.org); he was a member of the Scientific Committee of the Swiss Network for International Studies (www.snis.ch). He is a founder member of "Actares, Shareholders for a sustainable economy" (www.actares.ch). He was a founder member of the Ethics Committee of the Swiss Alternative Bank (Banque Alternative Suisse) and a member of the Board of Geneva's Caisse Publique de Prêts sur Gages as well as a member of the Council of the RAFAD Foundation, an institution that guaranteed micro-credit. Edward Dommen has been a university professor, but he spent most of his career before he retired as a researcher with the United Nations conference on Trade and Development (UNCTAD). e written and compiled several books on economic ethics. "A Peaceable Economy" (World Council of Churches 2014) was awarded the Daniel Colladon Prize 2015 as "the most remarkable Protestant work of the previous four years by a Geneva author".

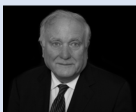
Jury member: 4th and 8th edition of the global Prize

Eelco Fiole is the managing partner of Alpha Governance Partners, which is focused globally on risk governance for sustainable and digital investment management. Dr. Fiole is also adjunct professor finance ethics at a.o. the University of Neuchatel. With almost 30 years in the industry, Dr Fiole has over 15 years of board-, COO- and CFO-experience, a.o. as CFO of the Tezos (blockchain) Foundation, and COO within Alternative Investments (AuM USD 17 bn) with Credit Suisse Asset Management. He gained advisory experience with a.o. PwC and started his career as an institutional banker with ABN AMRO. Eelco holds a PhD in economics (Basel) and further degrees in applied ethics (Zurich), social innovation (Cambridge), environmental governance (Geneva), blockchain technologies (Barcelona), positive leadership (Madrid), law (London), business administration, and mechanical engineering (both Rotterdam). He holds a.o. the CFA-, CDir-, QRD-, SCR-, CAIA-, FRM-, and IFQ-designations, is a Fellow of The Institute of Directors in London, and volunteers with a number of high-end bodies. Multilingual, he has 20+ years of substantial private exposure to China. Eelco is the 2022 recipient of the Inspirational Leader Award of CFA Institute for Ethics, a global recognition.

Jury member: 7th to 9th edition of the global Prize

Dr **Philippa Foster Back** has over 25 years of business experience. She began her career at Citibank NA before joining Bowater in their Corporate Treasury Department in 1979, leaving in 1988 as Group Treasurer. She was Group Finance Director at DG Gardner Group, a training organisation, prior to joining Thorn EMI in 1993 as Group Treasurer. She was appointed Institute of Business Ethics' Director in August 2001. Philippa Foster Back has a number of external appointments, including at the Ministry of Defence, The Institute of Directors and the Association of Corporate Treasurers, where she was President from 1999 to 2000. In 2006 she was appointed Chairman of the UK Antarctic Heritage Trust.

Jury member: 1st to 7th edition of the global Prize

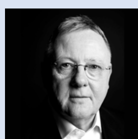


Dr **Andrew Hilton** is Director of the Centre for the Study of Financial Innovation, a London-based non-profit think-tank, supported by 70 City institutions, that looks at threats to and opportunities in the global financial system. The CSFI was set up 20 years ago, and has since published several books and around 100 reports. More significantly, it has organized well over 1,300 round-tables on issues of pressing interest in the financial services sector – including EMU, the single European market, the Internet, small business finance, high-tech start-ups, microfinance and regulation. Dr. Hilton also runs a small economic and financial consultancy. He has worked for the World Bank in Washington and has run a financial advisory service for the Financial Times in New York. He is a board member of the Observatoire de la finance in Geneva. He has a PhD from the University of Pennsylvania, an MBA from Wharton and an MA from New College, Oxford. He was appointed OBE in 2006.

Jury member: 1st to 8th edition of the global Prize

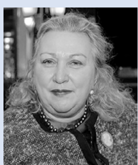
Prof. **Dominique Jacquet** is Visiting Scholar at Insead Social Innovation Center and Professor of Corporate Finance at Cedep, University of Paris Ouest and Ecole des Ponts ParisTech. He is a civil engineer (Ecole des Ponts), holds an MBA from Insead and a PhD from the University of Bordeaux. Before starting an academic career, he has been a finance executive in American and French corporations, holding controller, treasurer and CFO positions. His main areas of interests are the relationship with business and finance, the role of incentives in sustainable value creation and the link between uncertainty and financial strategy.

Jury member: 3rd to 9th edition of the global Prize



Prof. **Robin Jarvis** is Professor of Accounting and Finance at Brunel University. Robin was awarded the British Accounting and Finance Association (BAFA) Lifetime Achievement Award for his contribution to the advancement of accounting and finance to the academic community in 2013. From a European perspective Robin is a Special Adviser to the European Federation of Accountants and Auditors (EFAA) and a member of Finance Watch's Committee of Transparency and Independence. In the UK Robin is a Board member of the Genesis Initiative, a Director of the Registry Trust Ltd which he chairs their Audit and Risk Management Committee and Company Secretary and Director of Finance at Z2K. Robin has researched and published on SMEs, accounting and personal debt issues for a number of years resulting in numerous publications and 10 books. His interest in SMEs and accounting has been recognised through his membership of the International Accounting Standards Board (IASB) SME specialists groups and his past membership of the European Financial Reporting Advisory Group (EFRAG).

Jury member: 4th to 9th edition of the global Prize



Mrs. **Josina Kamerling** is Head of Regulatory Outreach at CFA Institute, responsible for supporting CFA Institute's policy development, in the Europe, Middle East, and Africa (EMEA) region, advancing the impact of advocacy efforts, and promoting capital market integrity and investor protection issues. Prior to joining CFA Institute, Josina was a Specialist Adviser on financial services in the European Parliament for six years, advising most significantly the Economic and Monetary Affairs Committee and the Special Committee on the Financial, Economic and Social Crisis on all aspects of financial services policy issues and technical information. Prior to this, Josina was a banker for 15 years in a variety of functions and locations, most notably as a senior banker in the global clients division of ING (managing a group of multinational clients on a worldwide basis and on all business lines) and prior to that as head of sales in the financial markets division of ING group (overseeing different sales teams in the dealing room). Josina holds a Bachelor of Arts with honours degree from Cambridge University in Law and modern languages. She is a Dutch national having lived and worked in five European countries, and she speaks five languages fluently (Dutch, English, Spanish, French, Italian, and some Greek.

Jury member: 5th edition of the global Prize
Co-chair: 6th to 9th edition of the global Prize

Patrick Krekels is General Counsel and Board Secretary of SWIFT. Patrick was appointed General Counsel and Board Secretary in January 2016. He joined SWIFT in 2001 as Deputy General Counsel. The Legal & Compliance team provides legal support and is responsible for regulatory compliance, corporate governance, Oversight affairs and legal risk management. Patrick studied Law (1986) and Economics (1987) at the University of Leuven, Belgium and obtained a Master of Laws (LL.M.) degree from the University of Illinois (1988). He is a member of the New York Bar. Prior to SWIFT, Patrick worked as an attorney at the Brussels Bar with the law firm De Bandt (now Linklaters) for 3.5 years and for Philips Electronics during 9 years (from 1992 until 2001). He was the General Counsel for Philips Electronics in Belgium and Luxembourg and was a Manager of the Corporate Legal Department in charge of M&A transactions and legal matters of Philips Research (Headquarters) in The Netherlands.

Jury member: 7th to 9th edition of the global Prize

Jean Laville has been active in the financial sector for 30 years, including 25 in the field of Responsible Investment. At SSF he drives the workstream on capacity building and education. Jean Laville is also a partner at Conser Invest since 2012, an independent advisory and asset management firm dedicated to sustainable investment solutions for private and institutional clients. He develops and runs quantitative tools enabling the systematic screening of the fund universe and the compliance of underlying holdings with ESG objectives. As Deputy Director he managed Ethos Foundation's and Ethos Services' from 2002 to 2012. Previously he held the position of ESG quantitative asset manager with Banque Pictet & Cie in Geneva, since 1998. In 1980, Jean Laville graduated in economics, majoring in political economy, from the Higher Business School (HEC) in Lausanne. He then followed the doctorate program from the Graduate Institute of International and Development Studies in Geneva.

Jury member: 7th to 9th edition of the global Prize

Geneviève Lhomme, PhD in Economics, has a various experience in the financial sector. She now chairs EFPA France, which she helped to create in 2009 and develop. EFPA France is a certification body in wealth management, affiliated to the European network EFPA, which brings value and coherence to wealth managers and financial planners. EFPA promotes ethical standards and professional skills. EFPA aims to harmonize best practices and strengthen the professionalism of the professionals to ensure the best possible protection for investors.

Jury member: 9th edition of the global Prize

Dr **Hakan Lucius** is Head of Stakeholder Engagement, Transparency and Civil Society at the European Investment Bank, the European Union's bank and largest supranational lender, where he covers the transparency and stakeholder engagement of the institution. Prior to that he was responsible for the financing of operations, ranging from large-scale infrastructure projects, structured operations, environmental investments to SME finance, both through loans and equity. Dr Lucius also serves as the President of the European Investment Bank's Pension Board. He is a member of the European Investment Bank Institute's Social Committee and of the Royal Institute of International Affairs, Chatham House. Dr Lucius received a Ph.D with distinctions in industrial economics, a MBA from INSEAD, France, and an MSc in Engineering from Vienna Technical University. He is also a Professor lecturing on Sustainability issues in Finance and on Cross-Cultural Management.

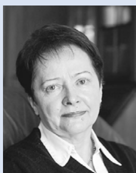
Jury member: 6th to 7th edition of the global Prize

Maggie Mcghee is Executive Director, Governance at ACCA since 1 October 2018. In this role, she has responsibility for both ACCA's corporate governance arrangements and the governance of ACCA members and students. Prior to this, Maggie was the Director of Professional Insights at ACCA, where she led a team of technical and policy experts to support ACCA's global thought leadership agenda. Before joining ACCA, Maggie worked for PwC in the Advanced Regulatory and Compliance Analytics area applying specialist analytics tool to clients in the banking and capital markets sector. A chartered accountant with a degree in law, Maggie trained with National Audit Office UK where she was the Director General of Audit. Maggie has been a member of a number of working groups and committees including the Accountancy Europe's Public Sector Working Group, the EU European Public Sector Accounting Standards (EPSAS) Working Group; HM Treasury's Financial Reporting Advisory Board in the UK; and the Financial Reporting Council (FRC) Audit and Assurance Council.

Jury member: 7th to 9th edition of the global Prize

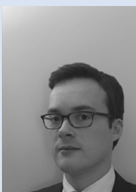
Mathilde Mesnard is Deputy Director for Financial and Enterprise Affairs of the OECD, covering financial markets, international investment, corporate governance, competition and anti-corruption. Previously, she was Coordinator of the New Approaches to Economic Challenges (NAEC) Initiative and Senior Advisor to the OECD Secretary-General. She launched an OECD-wide project on integrity and anti-corruption. From 2001-2009, she was an economist working on corporate governance and developed the OECD Guidelines on corporate governance of SOEs. Ms. Mesnard previously held positions as management consultant with Deloitte & Touche and Financial Analyst at Citibank. She holds a PhD in Economics from the EHESS, a Master's Degree in Finance from the ESCP, and an MBA from Drexel Universit.

Jury member: 7th to 8th edition of the global Prize



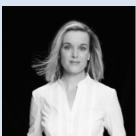
Dr hab. **Róża Milic-Czerniak** is an associate professor at the private economic university in Warsaw and is a member of the Banking Ethics Commission at the Association of Polish Banks. Previously, she has held a number of managing positions in one of the largest banks in Poland, where she was responsible for developing capital management, product management and client profitability concerning costs of risk, capital and costs allocation. She also participated in several projects, for example on the introduction of ICAAP, etc. Prior to joining the bank, she worked at the Institute of Philosophy and Sociology of the Polish Academy of Science in Warsaw, where she researched economic behavior of households, including in periods of transition (participating in international surveys and projects). She is the author of several books and research papers and spent one and a half year in Germany (at the Hohenheim University in Stuttgart and University of Kiel) under the Alexander von Humboldt-Stiftung scholarship.

Jury member: 4th to 9th edition of the global Prize
1st to 7th edition of the Polish Prize



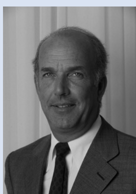
Mr **Ross Murdoch** is a lawyer at the Financial Conduct Authority (FCA) in London, within its Enforcement and Market Oversight Division. Ross specialises in regulatory enforcement proceedings, particularly within wholesale financial markets, including market abuse, benchmark manipulation (e.g. LIBOR), and other market misconduct. Prior to working at the FCA, he worked as a lawyer at a commercial law firm within its Commercial Dispute Resolution & Regulatory practice in London. He is dual qualified as a solicitor in England & Wales (2011) and Scotland (2010). In September 2015, Ross was awarded first prize in the Global Edition of the Ethics in Finance Prize (2014/2015). This was presented at a ceremony co-hosted by the Managing Director of the International Monetary Fund (IMF), Christine Lagarde, at its headquarters in Washington DC. From May 2019, Ross will be on a year long detail to the United States Department of Justice, Criminal Division, Fraud Section.

Jury member: 5th to 9th edition of the global Prize



Mrs **Clare Payne** is a leading voice on ethics and trust in society. She tracks trends and writes about their implications in her monthly 'Ethical Len's column in The Australian Financial Review BOSS Magazine. She is also the co-author of, 'A Matter of Trust – The Practice of Ethics in Finance'. Clare is a former employment lawyer who went on to manage the Integrity office of Macquarie Bank and founded the Banking and Finance Oath, a Hippocratic-type oath for the finance sector. Clare is an advocate for tobacco-free finance, which she sees as an ethical case study for the finance sector. Prior to the global financial crisis, Clare's paper titled, 'Ethics or Bust' was awarded the inaugural Ethics & Trust in Finance Prize by the Observatoire de la Finance, Geneva. Clare was recognised as a World Economic Forum Young Global Leader in 2014 and as an Australian '100 Women of Influence' in 2016.

Jury member: 4th to 9th edition of the global Prize



Mr **Charles Pictet** acted as a financial regulator in Switzerland from 2005 until 2012 in his capacity as a member of the board of FINMA. Prior to this, he worked at Pictet & Cie, a Geneva-based Swiss private bank, where he spent 25 years as a partner and senior partner. He was President of the Geneva Private Bankers Association, Vice President of the Swiss Private Bankers Association, and a member of the Board of the Swiss Bankers Association. He also served as Vice President of Economie Suisse. He is currently Vice President of the International Red Cross and Red Crescent Museum in Geneva (Conseil de Fondation), and a member of the Board of Europa Nostra. He holds an MBA from the University of St Gallen.

Jury member: 4th to 8th edition of the global Prize

Marta Rocchi is Assistant Professor in Corporate Governance and Business Ethics at DCU Business School, and member of the Irish Institute of Digital Business. Marta holds a PhD in Business from the University of Navarra (Pamplona, Spain) with a specialization on the ethics of finance, and an MSc in Economics and BSc in Economics both from the Sapienza University of Rome (Italy). Marta teaches Business and Professional Ethics; her research focuses on virtue ethics in business and finance, the new perspectives of business ethics in the future of work, and the ethical dilemmas of the digital world. She published in prestigious journals in the business ethics field: Business Ethics Quarterly, Journal of Business Ethics, and Business Ethics, the Environment & Responsibility. She was awarded the first prize ex-aequo of the Ethics and Trust in Finance Prize in 2019..

Jury member: 9th edition of the global Prize

Before joining the Graduate Institute, **Marie-Laure Salles** was the Dean of the School of Management and Innovation at Sciences Po Paris, a school that she helped to found, and Professor at the Centre de Sociologie des Organisations at Sciences Po Paris. Previously, she was also Dean of the Faculty, Dean of the PhD Programme and managed the Centre on Capitalism, Globalization and Governance at the École supérieure des sciences économiques et commerciales (ESSEC Business School) in Paris, all while simultanously occuping a post as professor. Marie-Laure Salles earned her PhD in Sociology from Harvard University and a habilitation à Diriger les Recherches from Dauphine University in Paris. Her work explores, from a historical and comparative perspective, the evolution of governance and capitalism; questions of business ethics and social responsibility; the role of networks in the diffusion of norms, practices and ideas; and the dynamics of governance, particularly transnational, in economic activities.

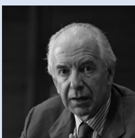
Jury member: 7th to 8th edition of the global Prize

Marie-Laure Schaufelberger is Head of ESG and Stewardship for the Pitet Group where she drives corporate strategy for the Pictet Group's Responsible Vision across investments and its own assets. She is also President of Sustainable Finance Geneva. Ms. Schaufelberger began her career at Pictet in 2007 in the media relations and public affairs team where she was also responsible for Corporate Social Responsibility initiatives. In 2014, she joined Pictet Asset Management's Thematic Equities team as a Product Specialist, covering business development and client portfolio management across several environmental and social thematic impact strategies. Ms. Schaufelberger holds a Master's degree in International Relations from the Geneva Graduate Institute and is a CFA charter holder.

Jury member: 9th edition of the global Prize

Mr **Brett Scott** is an author, journalist and economic hacker exploring the intersections between money systems, finance, digital technology and cities. He is the author of The Heretic's Guide to Global Finance: Hacking the Future of Money (2013), and collaborates with a wide range on groups on diverse topics, including banking systems, alternative currencies, financial activism, digital finance, blockchain technology, hacker culture, technology politics and the dynamics of cashless society. He has spoken at over 260 events in 32 countries, has written for publications such as The Guardian, New Scientist and CNN.com, and has appeared in a wide range of TV shows, radio and documentaries. He won third place in the 2016/2017 Ethics and Trust in Finance Prize for work on the ethics of fintech, and was also a finalist in the 2014/2015 prize for work on blockchain technology..

Jury member: 7th edition of the global Prize

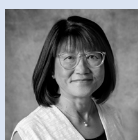


Mr **Domingo Sugranyes** graduated from the University of Fribourg (Switzerland) in 1969. He was Secretary General of the International Christian Union of Business Executives (UNIAPAC) based in Brussels from 1973 to 1981. He moved to Madrid in 1981 and joined the MAPFRE insurance group, a Spanish agricultural mutual which was at the time starting to grow internationally and has developed into a multinational insurance and reinsurance group now present in 44 countries. As one of the vice-chairmen of the group and Executive Committee member, he participated in the internationalisation and the demutualisation process and was in charge of Finance and Economic affairs. After retiring from executive office in 2008, he remained on the Board of the MAPFRE Foundation until reaching the statutory age limit of 70 in 2015. Since 2009 he is Chairman of the Centesimus Annus pro Pontifice Foundation, a Vatican body dedicated to spreading and debating Catholic social teachings in economic and business circles.

Jury member: 1st to 8th edition of the global Prize

Nathan Sussman joined the Institute in September as Full Professor of International Economics and Director of the Institute's Centre for Finance and Development. He was Associate Professor of Economics in the Department of Economics and in the integrated Philosophy, Economics, and Political Science Programme (PEP) at the Hebrew University of Jerusalem. He was the Director of the Research Department at the Bank of Israel and a voting member of the Monetary Policy Committee. His fields of expertise are monetary and financial economic history. He has written numerous articles and co-authored a book on emerging markets and financial globalisation. Professor Sussman earned his PhD in Economics from the University of California, Berkeley. He was Full Professor and Economics Department Chair at the University of Western Ontario in Canada, and served as Chairman of the Economics Department, Director of the Maurice Falk Institute for Economic Research, and Associate Dean of the Faculty of Social Sciences at the Hebrew University.

Jury member: 7th to 9th edition of the global Prize



Kara Tan Bhala is the President and Founder of Seven Pillars Institute for Global Finance and Ethics, USA, the world's only independent think tank for research, education, and promotion of financial ethics. Dr. Tan Bhala has nearly 30 years of experience in global finance and was Senior Portfolio Manager of the Merrill Lynch Dragon Fund. She has been a sell-side equity analyst, a sell-side equity salesperson, a buy-side equity analyst, a portfolio manager, and a lecturer in finance. Dr. Tan Bhala contributed a chapter "The Philosophical Foundations of Financial Ethics" in Research Handbook on Ethics in Banking and Finance. She is the lead author of International Investment Management: Theory, Ethics and Practice. Her forthcoming book is Ethics in Finance: Case Studies from a Woman's Life on Wall Street. Dr. Tan Bhala has a Bachelors (City, University of London) and Masters (Oxford University) in Business, a Masters in Liberal Studies (New York University), and a Masters and PhD in Philosophy (University of Kansas.

Jury member: 7th to 9th edition of the global Prize

Bernd Vilhauer is the Managing Director of the Global Ethic Institute (WEIT) at the University of Tübingen since January 2015. He studied philosophy, classical studies and history of art at the Universities of Freiburg i.Brsg., Jena and Hull (UK). After his PhD thesis on a cultural-philosophical topic (Aby Warburg and Ernst Cassirer), he worked in the publishing and media sector, most recently as editorial director of the publishing group Narr Francke Attempto. He taught as a lecturer at the universities of Karlsruhe, Jena, Darmstadt and Tübingen, on cultural and media science issues as well as theoretical and practical philosophy and economics. He is co-founder of the Institute for Philosophy of Practice e.V. in Darmstadt. Since 2013, he offers a seminar "Money and Ethics" at the Global Ethic Institute. He is also the initiator of the series "Klüger wirtschaften". His current work focuses on monetary theory, financial ethics and investment, topics he bloggs about in his "Finanz und Eleganz"Blog. Bernd Villhauer is currently writing a book "Finanzmarkt und Ethik.

Jury member: 7th to 9th edition of the global Prize

Joel Wagner is Full Professor in Actuarial Science at the Faculty of Business and Economics (HEC) and member of the Swiss Finance Institute at the University of Lausanne (UNIL). He is also member of the Board of Directors at Retraites Populaires and was previously part of the Swiss Occupational Pension Supervisory Commission (CHS PP). Before joining UNIL, he was Assistant Professor at the University of St. Gallen and a consultant at the Boston Consulting Group. He holds a PhD in Mathematics and an engineering degree in Physics from the Swiss Federal Institute of Technology in Lausanne.

Jury member: 7th and 9th edition of the global Prize

The Polish Prize

The polish edition has been organized since 2012 by the **Commission of Ethics in Banks at the Polish Bank Association** and is intended to contribute to the promotion of ethical attitudes in the financial sector, engage young people in discussions about ethical principles, the observance and correct identification of which is the foundation for the proper functioning of the sector.

The competition is a platform for discussion on the sustainable future of the financial sector strengthened by ethical awareness and commitment to its integrity. The jury in the polish edition is composed by the representatives of the Banking Ethics Commission, experts from banking and finance, recognized scientists dealing with ethics and finance. In each edition, the composition of the Jury is individually agreed. The work is always chaired by the Chairman or Vice-Chairman of the Banking Ethics Commission. The Co-Chair of every edition is prof. Paul Dembinski.

Observatoire de la Finance

The Observatoire de la Finance was set up in response to a question raised in the early 1990s: what is the social and economic "licence to operate" of financial markets? The corresponding report entitled *Financial markets: mission impossible?* was published in 1993 (http://www.obsfin.ch/founding-texts/financial-markets-mission-impossible/).

On this basis, three years later the Foundation "Observatoire de la Finance" was established in Switzerland as an independent, apolitical and non-confessional body.

Today, the Observatoire de la Finance is a *think tank* which work focuses on the complex interplay between financial techniques and practices on one side, and the requirements of the common good on the other. In doing so, it endeavours to clarify what is happening, and then investigates why..

The Observatoire's activities are aimed at:

• *Developing and formulating ideas.* The Observatoire engages in inquiry and multi-disciplinary diagnosis regarding selected aspects of the economy and finance and their relationship to society.

• *Proposing new leads and views.* Following this process of inquiry, the Observatoire compares, tests and refines the various diagnoses and the most promising avenues in consultation with the operators and institutions concerned.

• *Launching a dynamic process* to enhance the ethical content of the technical debate.

Director of the Observatoire de la Finance: Prof. Paul H. Dembinski

Members of the Board of the Observatoire de la Finance:

- Jean-Christophe Pernollet - Geneva
- Paul-André Sanglard - Porrentruy
- Jean-Michel Bonvin - Geneva
- Andrew Hilton - London
- Josina Kamerling - Brussels

Over the years, the high standard of its work and its ability to initiate dialogue and collaboration have given the Observatoire benchmark status in the field of financial responsibility and ethics. At a time of growing concern about ethics and sustainability, the Observatoire plans to develop further its activities and make them available to its academic and private partners as well as to the general public.

www.obsfin.ch

Staff Team

Mrs **Nati Garcia** studied in Geneva where she graduated in History and European Studies. Her professional career has centred around communications and event management for both public sector organisations and private sector firms. These have included the Observatoire de la Finance, Logistica de Actos SL and the School for Arabic Studies. She currently works in Accenture. She has coordinated the administration of the Prize since 2012.

Administrator of the Prize: 7th edition of the Global Prize

Dr **Virgile Perret** holds a Ph.D in Political Science from the University of Lausanne, for which he was awarded the Prize of the Faculty in 2013. He's specialized in the study of digital currencies and technological innovation from an interdisciplinary perspective. He collaborated with the European Commission, the International Labour Organization (ILO) and the State of Vaud. He contributes to the organization of the Prize since 2018.

Project Manager: 7th - 9th edition of the Global Prize

Mrs **Hannah Soissons** studied in France for a Master's degree in Economics and Finance, specializing Statistical and Economics Studies. She works at the Observatoire de la Finance on diffents projects, including managing the administration of the Prize since 2011.

Administrator of the Prize: 7th - 9th edition of the Global Prize

Where Ethics Matters in Finance

Ethics & Trust in Finance Global Prize Awards 2018–2023

Ethics in finance is not a mere regulatory requirement; it is the foundation upon which trust is built. It is therefore a shared responsibility between all market participants, intermediaries, and regulators to safeguard the integrity of our global financial system.

— **Jean-Paul Servais**, 2023, Chair of the International Organization of Securities Commissions (IOSCO)

It is essential that people trust banks and the financial services sector more widely. This is as important for the financial system itself as it is for individuals, as trust is the basis of all good and stable relationships.

— **Mairead McGuinness**, 2021, European Commissioner for Financial services, Financial Stability and Capital Markets Union

Financial systems are made of trust. Their strength stems from public confidence. This is why ethics in financial institutions are vital. This is why we need to reflect and debate about ways to make this sector more reliable, more accountable, more transparent, more inclusive.

— **Angel Gurría**, 2019, Secretary-General of the Organisation for Economic Co-operation and Development (OECD)