Does the Financial Sector Need An Ethics Reboot?

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A plethora of examples of ethical lapses in the financial sector around the world demonstrate that regulation is not enough. There is a need to bring ethics back into financial discourse, culture, and practice.

Europe's largest bank, HSBC, was recently fined £ 10.5 million for mis-selling products to elderly customers and another £ 29.3 million in compensation to the particularly vulnerable among them. The bank's subsidiary was trusted by these elderly customers but it sold them unsuitable products breaching that trust. In Bangladesh, amongst the poorest of countries, micro-finance was actively peddled among poor villagers with teaser rates that eventually led to indebtedness on multiple counts and usurious rates of interest. Weekly payment schedules, naming, shaming and other pressure tactics led to many suicides, in the South Asian region as micro-finance spread like an epidemic during the last decade. These apparently good social entities that make huge profits now (up to 125% per annum in some countries in Latin America) have come to be described as the "new loan sharks". Nobel laureate Muhammad Yunus observed while addressing UN financial officials: "…we did not create micro credit to encourage new loan sharks". It is estimated the majority of micro credit in the world is being operated by ruthless banks with eyes on "big profits from tiny loans", as a title reads.

In April 2011, the Reserve Bank of India levied a penalty on 19 banks that include global majors, for selling derivative products inappropriately to trusting semi-literate clients. This decision was a result of prolonged struggle by small-scale knitwear and hosiery exporters in Tirupur, a town in Southern part of India. Many of them went bankrupt due to exotic foreign exchange derivatives they were lured into buying. These school drop-outs and cotton-farmers turned entrepreneurs were sold derivative products which contained mind spinning clauses such as, "The exporter buys (and the bank sells) USD Call / CHF Put at strike 1.2300 for USD4 million with Knock Out @ 1.2400; The exporter sells (and the bank sells) USD Call / CHF Call at strike 1.2300 for USD8 million with

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Knock Out @ 1.24, Knock in @1.12;" Double One touch option with trigger 1.2270 and 1.2330 with pay off USD 50000 on maturity".

These individual episodes, indictments, penalties and scams around the world were never a worry for the mighty financial sector till recently, which remains towering in its influence across borders. But, the Wall Street protests following the North Atlantic and Europen crises have symbolized the growing mistrust of big banks in particular and the financial sector at large, especially in the developed world. It is at least providential, if not due to wise regulation as some would like to argue, that many important emerging market economies escaped this ignominy. The world-wide acclaim of the stinging judgement by Judge Jed Rakoff in October, 2011 – rejecting the proposed $285 million settlement between the SEC and Citigroup Inc. – is further evidence of the lost credibility of an important economic institution. The judgement underscored the cosy relations between the regulators and the big banks that some would call as misplaced regulatory forbearance, if not evident capture. The judgement concluded that the settlement appears to be a sop to the culprit in question with "small change"-sized levy without admitting to any guilt.

Despite some early attempts to disconnect the financial crises from the severe economic crisis that followed, many have realized that the economic, political and social turmoil across the world during 2008-2011 may have a common parent – the financial bubble that burst and exacerbated other tensions. The irresponsibility, greed and other human weaknesses that were stoked up, in the cause of free markets and in the hope that markets would discipline the participants, proved too expensive for the world. Entering the choppy waters of 2008, many began questioning the manner in which regulation was eased up in important economies during the last two decades - burning the fire walls between ordinary banks and investment banks, and creating a permissive environment for financial engineering that brought in much waffle. In most of the advanced economies, the sector that was meant to service the real sector began to grow for its own sake resulting in a massive jump in revenues and profits. Salaries of employees in this sector also overtook the real sector. Products out of financial innovations began gaining a life of their own leading to fictitious assets, prices and bonuses. So much so that Lord Adair Turner, Chairman of the Britain`s Financial Services Authority has reportedly commented that much of what happens in financial centres as "socially useless activity". Many now believe that the financial sector, which has been extracting rents from the real sector, should be seriously downsized.

Commenting on the financial leviathan in the USA, Bradford DeLong, says that there are no obvious benefits of either micro or macro level, to justify spending on extra 5.6% of GDP every year on finance and insurance, that has grown massively. He seems to conclude that the growth in finance is not necessarily due to a rising share of financial professionals that match people with risks with those who have the risk-bearing capacity. On the other hand, it could be due to unprofessional players matching risks with people who are clueless but have the money. This perspective is validated by the examples cited earlier and the penalties, even if eventually merely "small-change".

It is no wonder that the US Financial Crisis Inquiry Commission was informed by the Chairman of the Federal Reserve that while some financial innovations amplified risks, others facilitated unfair advantage rather than create a more efficient market. The public believes, at least since the 2008 crisis, that the financial sector has been rewired over the years to sin more than to add net value to the society. Such widespread dismal sentiment has affected the prospects of liberalization and planned reform in many emerging market economies.

In the UK and the USA the lack of sensitivity and the singular obsession for money was commented upon when bank chiefs paid themselves hefty salaries after symbolic restraint even as the financial entities were surviving on public financed bail-outs. Barclay's CEO, Bob Diamond, indeed asserted before the UK's Treasury Select Committee that the period of remorse and apology needs to be over and that business must go on as before. Leaders in the sector justified their salaries more on the basis of celebrities in soccer and Hollywood than teachers and nurses. Many refused to acknowledge the huge adverse impact on a generation of people and the social cost due to their greed and irresponsible actions that spawned the world-wide crises. It is no wonder that the Financial Crisis Inquiry Commission drew attention to the systemic breakdown in accountability and ethics – of an erosion of standards of responsibility and ethics stretching from the ground level right up to the corporate suites. This erosion in ethical standards was symbolised when only a fraction of management graduates from leading business schools (20 out of about 520 students in one case) were willing to sign the ethics pledge. Ironically, one Professor saw the bright side to this dismal situation saying that at least most of the students were honest enough to admit how they might carry themselves forward. Some consolation.

Such commitment to profits and career growth over ethics, such mindless remuneration that has no relationship with need or comparisons, such absence of sensitivity to growing social inequity and social costs of bail-outs is indeed appalling. The anger exhibited in social protests against the financial sector seem justified to many. Some wonder whether this sector has somehow conjured up conducive conditions for sociopaths to emerge as leaders – whether a behavioural distortion has been inadvertently injected into this sector during the last two decades. Lack of concern for others and absence of guilt are considered typical symptoms of sociopaths. Much evidence goes to show that some in this sector are nowhere near accepting the guilt but are working overtime to counter regulatory moves. They continue to socialize the cost of their irresponsibility and aggression irrespective of the implications to livelihoods of millions of the deprived.

It is possible that during the last two decades some people in this sector have developed insulation from ethical considerations. The remoteness of much of their work from the common people, the invisibility of services by nature, the futuristic nature of contracts and the opacity of transactions probably induces exclusivity. In the extreme, it could result in aloofness that may be seen in fighter bombers operating from great heights or those firing long range missiles. In the course of these two decades, some in this sector have subjected themselves rather innocuously, to an ethical bypass in the neuro-system.

It is apparent from the series of individual and institutional level episodes that the people involved in decision-making have probably kept a convenient frame of reference and the pay-off in mind than the standards inherent in their professions and the common perceptions of correctness. Thus, many examples show that professionally trained managers are prepared to compromise ethics to improve their performance rating, bonuses and corporate results. Regrettably, business schools and professional courses have emphasised the importance of competitive advantage and success measured in financial terms. The media has indeed done its bit in its attention to the equity markets, the size of corporations and their wealth. For long, many business schools did not even assign credits for courses on ethics. There indeed appears no place for sessions on ethics in most of the executive development programmes. (A dip stick examination of about 100 executive development programmes with an average of 2500 sessions had only 10 sessions related to ethics.) International programmes on Corporate Governance for Directors deal with all else including sustainability issues, except ethical conduct and real-life dilemmas. These conditions of insulation from ethics and ethical considerations must be turned around quickly.

Professionals in the financial sector must bear in mind that most unethical actions are at the individual level and are of individual choice. Organisational expectations, group think, peer pressure may induce complacency and poor judgement in making choices. The first defence against ethical complacency is to build capacity among all to internalize ethical standards and know immediately when faced with a decision that includes an unethical choice. The next step would be the appreciation of the linkages between ethical conduct at work, quality of life, and their impact on the family.

A major correction is required to get the financial sector back to its role of serving the real economy and reaching out to all inclusively and ethically. To rebuild public confidence and reduce the massive trust-deficit, it is necessary to have a demonstrated, publicly announced and committed effort by a central think-tank or advocacy group. Such an effort may begin with a planned approach to installing an ethical compass in all employees and participants in the sector. Is The Seven Pillars Institute in the best position to initiate a policy dialogue on this and take it forward?

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