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Why Do We Need Morality in Finance if We Have Laws?

Carolina Rocha*

Abstract: The global financial system is currently so deeply embedded in every economic activity that its stability and health have become critical factors in determining world economic output. A substantial increase in regulation attempts to create a more solid and reliable system. However, this article proposes that more regulation cannot, and will not, be sufficient. Particularly, it suggests that given the characteristics of the financial world: (a) legislation by itself is not enough to guarantee, neither in theory nor in practice, a solid and reliable financial system, and (b) legislation and morality is a good pairing.

"What is needed is a culture that induces bankers to do the right thing even if nobody is watching."

Christine Lagarde,
Managing Director of International Monetary Fund
Finance and Society conference, May 6 2015

According to estimations by McKinsey Global Institute, Haver Analytics, Bank of International Settlements and Deutsche Bank, as of 2014 global financial assets total almost $300 trillion[1]. The amount is staggering, which explains why distortions in the financial service industry often cause massive monetary loses. Still, the harm the financial system is capable of imparting to the real economy is not exclusively due to its magnitude, but also to its breadth and its ubiquity.

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* Carolina Rocha is an economist and has an MBA from Harvard Business School. She is a business consultant for her family's business and an economic researcher trying to make a positive impact on the world. She has published several articles and papers and won various international awards.

[1] *Global stock market cap has doubled since QE's start* by Wallace Witkowski, MarketWatch, February 2015.

For the last few decades, globalization of national economies and liberalization of domestic capital markets have created an ideal environment for the advancement of the financial industry. Lower international barriers along with groundbreaking advances in information and computer technology have encouraged financial services providers to ignore frontiers and flourish. This more inclusive perspective stimulates global competition and promotes international exchange, irreversibly connecting most financial markets around the world.[2] Today, the system has attained sufficient scale to rapidly propel to international levels, regional economic events, heightening impacts, positive or negative.

Recently, finance also has decisively invaded everyday life, penetrating all aspects of modern society (*e.g.* health, education, housing), a process known as "financialization". This more integrating paradigm further empowers the financial industry, positioning it as a primary player in the global system. Leveraging this new interdependence, financial instruments now have the capacity to spread sector-specific phenomena across the entire economy, amplifying the scope of both adverse and favorable outcomes.

In this context, understandably, when the financial sector stumbles or collapses, authorities act fast to minimize repercussions and reestablish trust. According to Professor John Francis Diaz[3], the governmental response is usually to increase the number of regulations and tighten the severity of penalties. However, he firmly believes that instead of preventing and settling crises, financial regulations are lately, expensively and extensively, harming the corporate environment by constraining business operations and undermining fair competition.

With this in mind, finding a supplementary framework capable of inspiring, more efficiently or effectively, the desired behavior in the financial industry seems imperative. This article proposes ethics as the answer. In general terms, the rationale is that good governance is indeed achievable from within the organization, obtainable by encouraging self-regulation, promoting individual integrity and increasing personal accountability. Nonetheless, the main purpose of this article is a first step in the journey. Specifically, the intention is to demonstrate that given the characteristics of the financial world: (a) legislation by itself is not enough to guarantee, neither in theory nor in practice, a solid and reliable financial system, and (b) legislation and morality is a good pairing.

[2] *The Globalization of Finance* by Gerd Hausler, International Monetary Fund, March 2002, Volume 39, Number 1.

[3] *Financial ethics in the financial industry* by John Francis Diaz, TEDx CYCU, June 2015.

Legislation is not Enough: the Case for a Moral Framework in the Financial Sector

Society at times seems chaotic, almost barbaric. Still, unexpectedly, order always prevails, which enables life in communities. To secure order, civilizations create frameworks, consensual sets of standards that guide human conduct. These systems of norms, explicitly define what is appropriate behavior and what is not.

Frameworks vary in nature. Among others, there are religious ones, binding only for those who profess faith; regionals, relevant solely to those within a particular culture, etc. Arguably, no framework is universally better than any other; being simply different, complementary in certain scenarios and interchangeable in others.

As frameworks, both legislation and morality intend to guide human behavior; yet, they use different types of incentives. While the first operates mainly through threats and sanctions, the latter employs reinforcement techniques: wrongdoing leads to personal guilt and social criticism, whilst good acts result in positive feelings and social praise.[4] Nonetheless legislation and morality often agree. Murder is both immoral and illegal; slavery is similarly immoral and illegal, and so on. However, for some topics, only one of the frameworks, either legislation or morality, applies, while the other has no opinion on the subject. For example, cheating is usually immoral but rarely illegal; on the other side, private property is contemplated in the law, but is less likely to have moral dimensions. As a consequence, due to the complementary potential, in some fields, implementing both frameworks together proves beneficial. The financial industry is one of these fields. To understand why, the next section analyzes further the relationship between legislation and morality.

The theoretical perspective

According to Steven Shavell from Harvard Law School, exclusively from a theoretical point of view, legislation exhibits several advantages over morality when trying to regulate, successfully and efficiently, human behavior.[5] Explicitly, law: (i) is less expensive[6], (ii) employs specific and pre-established processes (iii)

[4] *Law Versus Morality as Regulator of Conduct* by Steven Shavell, Harvard Law School, American Law and Economics Review Volume 4, N2, 2002, p.227-257.

[5] Ibid, p.227-257.

[6] This might sound counterintuitive because the marginal cost of teaching one additional person about morality is practically zero, however think about the total cost of educating the young generations about what society accepts as wrong or right. As a whole, the cost of morality is undoubtedly higher than just establishing it as law.

is flexible, (iv) allows complexity, (v) applies severe and precise sanctions, (vi) prevents the repetition of bad conduct by imprisonment, and (vii) is applicable to amoral subjects.

Similarly, when pursuing the same objective, morality also holds theoretical advantages over legislation: (i) it does not request external witnesses, (ii) it operates with complete information, as one cannot hide evidence from oneself, (iii) it has low enforcement cost, and (iv) it does not affect market dynamics.[7]

These two complementary sets of benefits suggest that, from a theoretical perspective, morality and legislation are needed together to satisfactorily regulate a particular field when the following conditions appear simultaneously:

- Personal gains from undesirable behaviors are potentially large and thus are not discouraged exclusively by morality.
- Misconduct is likely to pass unnoticed by others, hence moral sanctions are improbable.
- Wrongdoings are capable of imparting severe harm to others so expected economic losses outweigh the cost of implementing a legal system.
- Amoral parties are involved, as morality simply has no jurisdiction.
- Morality is not aligned with ethics, thus legal rules are necessary to incentivize ethical behavior (*e.g.* not reporting a friend as an act of loyalty).
- Legal rules do not apply hence morality is needed to ensure ethical conduct.
- Relevant information is only known, accurately and completely, by the own individual, thus legal assessment is less precise than moral appraisal.
- Legal sanction results are not severe enough to deter ill behavior.
- Morality, by accompanying legislation, is able to reduce regulation costs.

It seems then, that in theory, the financial sector would benefit from implementing legislation and morality together. Consider the following operating conditions of the financial industry that meet the criteria listed above:

- Personal monetary gains from undesirable activities can definitely reach colossal dimensions.
- History has proven that unethical behavior frequently pass undetected, even under rigorous control systems.
- History has also proven that mainly because finance is extremely intertwined with other areas of modern life (*e.g.* housing), wrongdoing can be particularly harmful.

[7] Legalization influences market dynamics in multiple ways, for instance by implementing fees or assuming imprisonment cost, etc.

- Firms, always present in financial settings, are amoral[8].
- Unethical actions are often masqueraded as moral ones in financial environments, mainly due to peer pressure and commonly accepted practices.
- High levels of innovation across the entire industry have precluded the legal system from considering every plausible scenario, which frequently causes situations, instruments, or activities to be outside the scope of the law.
- Intangible variables such as intention and degree of knowledge, play a critical role in finance, but are completely and accurately known only by the own individual.
- Legally imposed sanctions, normally in the form of fees, have shown to be frequently not enough to dissuade misconducts.
- Lastly, the cost of increasing formal regulation in the industry, especially after several crises, has become massive, which suggest that implementing a moral system with better incentives, can replace some rules and reduce total costs.

The practical perspective

According to John Boatright, author of *Ethics and the Conduct of Business* and *Ethics in Finance*, merely from a practical point of view, morality is necessary in business settings, even if there is a robust legal system in place, when:[9]

- Legislation cannot regulate all aspects of the activity, either because it is too unpredictable to anticipate, too complex to reduce to concrete rules, or too difficult to sanction adequately and effectively.
- Laws are developed mostly as a reaction to unethical situations in the activity.
- Employers, customers or other stakeholders, expect or demand moral treatment.

Taking into consideration these practical aspects, it becomes evident again the financial industry should consider morality an important part of its practice, even if already regulated by a vast body of law. There are good reasons for doing so.

First, legislation has, especially lately, attempted to function as an impenetrable wall to shield the real economy from the financial industry. However, in practice, the task has proven rather challenging. For instance, financial markets are almost

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[8] It is important to notice however, that some authors (e.g. Richard De George in *Business Ethics*) consider firms to be essentially a sum of people and thus moral subjects.

[9] *Ethics in Finance* by John R. Boatright, 2014, Third Edition, p. 15-16.

perfectly competitive, thus innovation becomes key to achieve success. As a consequence, constant changes and experimentation are common in the industry, making the activity unpredictable and difficult to summarize in static norms. Similarly, financial instruments often involve abstract concepts and sophisticated transactions, which makes most operations difficult to describe in precise rules. In other words, finance, in the eyes of the law, appears excessively complex in its dynamics and too hard to anticipate, preventing legislation from effectively regulating every aspect of the activity.

Secondly, crises and unethical scandals have historically inspired laws in the financial industry, particularly in well-developed legal systems where unethical actions quickly become also illegal. The recent crisis is the perfect example. Formal regulation regarding specific financial instruments was formulated only after the bubble burst. Marc Quintyn, author of *Principles versus Rules in the Financial Supervision, Is There One Superior Approach?* believes that this cause-effect relationship has created, within the industry, a culture where everyone tries to find a legal loop to make an extra dollar or attempts to extend the time profitable actions are not illegal.[10] Unfortunately, this game cannot be won. Laws will always react to schemes and crunches, and financial agents will always try to delay regulation.

Lastly, a strong positive reputation is the most valuable asset any financial institution can hold. To develop good reputations, firms have to, consistently, meet or exceed customers' standards. Given that most of these standards emerge from morality, in a way, customers are indeed demanding financial agents possess a moral conscience.

Final Remarks

Adam Smith envisioned the capitalist system, in which the financial sector is a main player, as the most efficient mechanism to generate national wealth. That part of the story is the one most people know and remember, but there is more. Smith placed at the center of his plan, to manage capitalism, a moral individual, a person with prudence, restrain, frugality, sobriety, honesty, civility and

[10] *Principles versus Rules in the Financial Supervision, Is There One Superior Approach?* by Marc Quintyn. http://www.financepractitioner.com/contentFiles/QF02/g1xtn5q6/12/4/principles-versus-rules-in-financial-supervisionis-there-one-superior-approach.pdf. Accessed May 2016.

reliability.[11] If from its conception capitalism was to be moral, why would finance be an exception?

The financial industry has had a bad reputation since the beginning of times, before Wall Street or the Great Depression. It has even served as inspiration for some of the most famous and despicable characters across classic and modern art forms;[12] even the Bible positions finance as the devil among demons.[13] The list goes on. Some of the caricaturist images have disappeared today, but the financial sector is still infamous and for many, also unethical. For example, Jay L. Walker, author of *The Complete Book of Wall Street Ethics*, claims that his book fills "an empty space on financial bookshelves where a consideration of ethics should be"[14] but its pages are blank.

In the academic world, broadly speaking, those who are still suspicious of the financial industry base their arguments on the supposition that financial activities are substantially different from day-to-day life, where morality is normally formed and applied. In other words, it believes there is no common ground plausible – ethics is relativistic and discursive while finance is empirical and rational.[15] The specific justifications vary, but three can be easily identify: (i) financial theory is based on economic models that have no room for morality and are based on self-centered individuals solely trying to maximize monetary wealth, (ii) finance is exclusively concerned with money, which has been long associated with greed and immorality, and (iii) finance is a highly technical activity, constantly using abstract concepts that are both foreign and incomprehensible to most people.[16]

However, this article is a reminder that including morality in finance is, currently, a necessity, not a choice. Particularly, the article has briefly exposed theoretical and practical reasons that suggest finance is too vast, too complex, too disperse and too global to be regulated solely by one framework, either legislation or morality. Marc Quintyn writes: "In the aftermath of a crisis, all sides call for more

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[11] More on the subject can be read in my paper "Reimaging Capitalism" in *Moral Cents: The Journal of Ethics in Finance,* Vol 4, Issue 2, Summer/Fall 2015. Web. http://sevenpillarsinstitute.org/wp-content/uploads/2015/11/Reimagining-Capitalism-EDITED.pdf

[12] "Businessmen are always the villains." *The Economist*, October 2015 *http://www.economist.com/blogs/prospero/2015/10/money-film*. Accessed May 2016.

[13] Matthew 6:24: "No one can serve two masters. Either you will hate the one and love the other, or you will be devoted to the one and despises the other. You cannot serve both God and money."

[14] *Ethics in Finance* by John R. Boatright, 2014, Third Edition, p. 1.

[15] *Ethics in Modern Finance Theory, Our Quest,* Seven Pillars Institute, http://sevenpillarsinstitute.org/mission/quest. Accessed May 2016.

[16] *Ethics and Finance, An Introduction* by John Hendry, 2013, p.37-45, Cambridge University Press.

rules; in quiet times, all sides think that they can steer the course with principles. As normal times inherently carry the seeds of a crisis within them, any supervisory system should balance rules and principles."[17] The best alternative to contemporary models is to create a balance, by adopting a supervisory approach that will offer principles supported by guidelines and rules.

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[17] *Principles versus Rules in the Financial Supervision, Is There One Superior Approach?* by Marc Quintyn. http://www.financepractitioner.com/contentFiles/QF02/g1xtn5q6/12/4/principles-versus-rules-in-financial-supervisionis-there-one-superior-approach.pdf. Accessed May 2016.