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Finance and Virtue Ethics: Aristotle, MacIntyre and Catholic Social Teaching

Andrea Roncella*

Abstact: This paper proposes that it is necessary to understand the ethical as the root cause of many wrong financial and economic decisions. It applies virtue ethics frameworks drawn from Aristotle, Alasdair MacIntyre, and Catholic Social Teaching. The paper applies natural and unnatural chrematistics (the study of wealth accumulation) to distinguish between the ethics of market-making versus that of high frequency trading. The failure of the Reserve Primary Fund is seen through the lens of MacIntyre's external and internal goods. Finally, Collateralized Debt Obligations are measured using principles of Catholic Social Teaching.

Introduction

The 2008 financial crisis was a watershed in financial history. The years before Lehman Brothers' bankruptcy, an event marking the climax of the crisis, were characterized by a generally accepted trust in liberal society. In its economic component, liberalism relied on market forces alone to attain prosperity and growth. The events between the summer of 2007 and the autumn of 2008 acted as a rude awakening to the limits of an economic development driven mainly by debt and financial innovation (King 2016). Even in academia few emphasized the risks behind mounting euphoria of the financial sector (Rajan 2006). The warnings were largely ignored. Since then, and in particular following the enormous and non-market leaning intervention of the US government and US Federal Reserve to

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* Andrea Roncella is currently working on his Ph.D at the University of Navarra (Pamplona, Spain). He previously worked as Research Fellow at the Markets, Culture and Ethics Research Centre at the Pontifical University of Santa Croce (Rome, Italy). Andrea holds an MSc in Economics and Finance and BSc in Economics and Management from the LUISS University (Rome, Italy).

prevent the worst consequences from spreading in the real economy, there has been a change in the way of assessing the alleged benefits brought by finance to society and people.

Two Areas of Change Post 2008

The change has been directed in two areas. The first is the institutional aspect, and specifically a more stringent regulation of financial institutions. The introduction of the Dodd-Frank Act in July 2010, the Basel III proposal made by the Bank of International Settlements to strengthen international banking supervision, and the European MiFID II (Markets in Financial Instruments Directive) in 2014 to regulate the European financial markets, are concrete examples of the government attempts to repair market malfunctions or to encourage greater consumer protection. Without entering into details and consequences of these regulations, it is nevertheless clear that in the ten years following the crisis regulators have a renewed vigor in turning back the *deregulation* regimes of the 1980s and '90s.

The second aspect is the significant growing interest in the ethical or cultural dimension of the financial sector. In the wave of general fury following the crisis, a significant concern was raised about ethics, and its absence in financial agents (The Economist 2013). An agreement on the roots of this dearth of ethics has not yet been achieved. Opinions divide between those who argue that its origin should be sought, for example, in the new system of incentives that threatened the traditional values of financial institutions (Santoro and Strauss 2012), in the type of education offered in Business Schools (Ghoshal 2005; Giacalone and Wargo 2009), and in the widespread incompetence of various parties involved (De Bruin 2015). However, it is undisputed this greater awareness of the importance of ethics allowed for a better understanding of economic and financial events.

This paper argues these two components, institutional and cultural, are the foundations that must support a healthy finance industry, one capable of contributing to economic growth that serves society and people's happiness. Therefore, this paper contributes to the debate on the second dimension, namely the ethical or cultural one. To talk about ethics, however, requires first and foremost a clearer specification given the lack of accepted clarity of this term.

The Necessity of Normative Ethics

The starting point is normative ethics, the study of human behaviors not only with regard to what they are, but also how they *ought* to be. In the paper, we refer to the available data, but an exclusively empirical analysis is insufficient for the stated purpose because moral judgments are not necessarily within its purview. For example, *behavioral economics*, in its application to finance, seriously questions the results of the 'efficient market hypothesis' on which modern finance is built (see for example Gennaioli and Shleifer (2018) for a *behavioral finance* account of the 2008 financial crisis). Thanks to the contributions of other sciences, and in particular psychology, *behavioral finance* has achieved a more complete description of human behavior than models based exclusively on efficiency and rationality (Akerlof and Shiller 2009; Shiller 2015). Despite its fundamental contribution, behavioral economics remains within a descriptive parameter of events, and hence it neither explicitly suggests whether a certain behavior is good or not, nor according to what criterion a particular action is more or less desirable. To make this step, it is necessary to use a different lens and to adopt a normative approach.

Three Traditions of Normative Ethics

Three great traditions are found within normative ethics (Rodríguez Luño 1993). The first and most widespread in the economic field is 'utilitarianism'. Its contribution lies in judging a particular action according to the consequences produced in terms of greater or lesser pleasure, more commonly associated with utility nowadays. The neoclassical economy, which describes economic decision making processes, favors this ethical approach. Utilitarianism is most applicable when modelling human behavior (Sen 1999). If it is assumed that human beings make decisions with the aim of maximizing utility, it is possible to formulate objective functions through which human behavior can be described and future agents educated. There are weaknesses to this approach, but here we simply want to point out that utilitarianism is criticized for its reductionism. Behavioral scholars stress this point (Kahneman and Tversky 1979), criticizing utilitarianism firstly for its assertions about the reasons behind certain actions, and secondly for its exaggerated focus on individual actions that do not take into account the general context of the agent.

A second particularly widespread tradition is 'deontological'. This approach links the judgment of an action to the respect of a norm, both as a principle and as a law. Deontological ethics appears an attractive choice for business ethicists, and indeed, important handbooks of finance and ethics make reference to it (Boatright 2013; Bowie 2017). However, if we identify the norm with respect to the regulation, our analysis will merely ascertain the legality of a certain action without identifying whether this action is also ethically good. Moreover, regulation often suffers from a temporal gap because it intervenes *ex-post* to remedy events that were not illegal at the time they were realized. If instead we consider the norm as respect for some moral principles, the analysis runs the risk of falling into a universalist absolutization, one that is not terribly relevant for practical purposes, as it does not consider the purpose or intention of a certain action, both of which are central when making a moral judgment.

Finally, a last strand within normative ethics is that of 'virtue ethics.' This approach, which has its roots in the classical thought of Plato and Aristotle, was revived after a long absence from the public discourse, by the works of Anscombe (1958) and MacIntyre (2007). A key characteristic of this approach lies in the observation point when assessing an action. Both deontology and utilitarianism adopt an approach called, the 'third person', where an external observer asks about the legitimacy/utility of a certain action. Conversely, the perspective of virtue ethics is of the 'first person', who when faced with an ethical dilemma asks, "what kind of person do I want to be?" and "what does a good life consist of?" (Abbà 1996). By adopting this approach, it allows for a richer comprehension of human behavior, encompassing the principles, intentions and consequences of a certain action, and embracing a holistic perception of an agent, as a person who performs different roles in the search for the good life.

This article utilizes some of the most important resources of virtue ethics to study concrete financial institutions. By doing so, it overcomes the criticism of abstractness or irrelevance historically attributed to the subject of *business ethics* (Carr 1968; Stark 1993), and bridges the gap left by the *separation thesis*, which holds that the world of ethics lies apart from that of positive economics.

Virtue Ethics

Aristotle is one of the founding fathers of virtue ethics. Central to the Aristotelian project is the study of the nature of the supreme good for man, defined as *eudaimonia* and usually associated with human flourishing or happiness (Aristotle 1985). Given the nature of human beings as 'political animals', flourishing can only be achieved within political communities. Furthermore, flourishing depends on external, or material goods on one side as well as internal, or goods of the soul, on the other. To attain happiness, material goods should be pursued only as a means to obtain internal ones. In a similar manner, we must be able to distinguish the elements that configure a proper economy, differentiating between a natural and an unnatural accumulation of wealth. The Greeks called the accumulation of wealth *chrematistiké*. The natural accumulation of wealth or natural *chrematistiké* provides a service to the economy and contributes to the achievement of those external goods on which the flourishing of men depends. An unnatural accumulation of wealth or unnatural *chrematistiké,* being an end-goal in itself, is rather a threat to happiness given that a means is treated as an end.

In the tradition of economic thought that internalized Aristotelian insights, such as that of the School of Salamanca, the scheme *oikonomia – chrematistiké* has been useful to assess controversial practices such as that of *usury*. In entering into this tradition we acknowledge that with respect to Athenian society, economics reasoning has been enriched with concepts such as *opportunity cost* that eventually invalidate some of the conclusions of Aristotle. Nonetheless, our guess is that the distinction between natural and unnatural *chrematistics* is still valid in recognizing the contribution of a financial innovation to the society.

Natural and Unnatural Chrematistics

Market-making versus High Frequency Trading

An interesting case in this sense regards the evolution of a fundamental activity in the financial markets, such as that of *market-making*, which has been radically transformed by the spread of the *high-frequency trading. Market-makers*' role typically consisted in an intermediary position between sellers and buyers in order to provide liquidity and to guarantee 'fair and ordered markets' in exchange for a profit (the *bid-ask* spread). The centrality of such a role was evident in particular during times of low liquidity, due to a mismatch between supply and demand. Despite the unavoidable scandals (e.g. the crash of the U.S. stock market in 1987), it is worthwhile underlining how the activity carried out by the 'old' *market-makers* can be read as lying within an 'economic cycle' in which their trading activity (a means) was at the service of a common good such as the supply of a continuous liquidity (an end).

Conversely, the substitution of classic *market-makers* with *high-frequency traders* (whose story is recalled by Lewis 2014), meant a revolution of stock market transactions for which a reduction of the *bid-ask* spread (a transaction cost for the investors) happens at the expense of a greater volatility of the markets (exemplified by the Flash Crash of May 6, 2010). This is due to the fact that the new 'market-makers' offer liquidity as a profit strategy. If this means better liquidity during normal markets times, it is also true that during stressed markets – and hence, when the need for liquidity is greater – the *high-frequency traders* actually withdraw liquidity, leading to a worsening of the situation on the markets and betraying the typical function of a *market maker*.

The introduction of *high-frequency trading* meant a shift to an unnatural 'chrematistic cycle' where the liquidity provided is in fact instrumental to the trading activity. This upsetting of *ends* and *means* reveals two issues. Firstly, it masks the agents' eagerness for accumulating wealth, one that Plato defines as *pleonexia*, and that is a hindrance to happiness, rather than a means of achieving it. Secondly, it is the cause of the corruption of the market-making activity that eventually results in an increased systemic instability.

MacIntyre's External Goods and Internal Goods

Reserve Primary Fund (RPF)

This connection between a limitless search for an instrumental good, that causes damage to the quest for the good life of financial agents and a general systemic problem is of particular importance. The wealth seeking behavior constitutes the thread of our research. The moral 'corruption' of the agent entails the 'corruption' of the institutions within which she operates and therefore, instigates a domino effect, upon and within the system in which the institutions are embedded. The link between the cultural component, specific to the single financial agent, and the institutional dimension rests on what MacIntyre defines as 'practice'. This concept is part of the broader scheme of 'goods-virtues-practices-institutions' (MacIntyre 2007), and it has been of particular help in framing a frequent problem in the financial sector: an almost exclusive focus on what MacIntyre calls 'external goods' (such as fame, success, profit). Focus should instead be given to the pursuit of 'internal goods', or the good of excellence. This imbalance in favor of instrumental goods constitutes the corruption of the 'practice' and connects the moral error to the gradual decay of the institution, which in the MacIntyrean scheme hosts the practice itself.

This framework can be applied to the concrete case of the Reserve Primary Fund (RPF), a money market mutual fund that played a central role in the crucial stages of the 2008 financial crisis, and its founder, Bruce Bent. The financial literature underlines correctly the institutional problems behind this institution, but no one asks whether the decision made by Bruce Bent to shift the investment strategy to invest in commercial papers, that eventually led to the collapse of the fund, was morally legitimate.

Founded in the early 1970s by Bruce Bent, the RPF had for almost 35 years, represented the ideal of a money-market fund, a financial vehicle for investments with very low risk, and returns just above those of government bonds. The success of the money-market funds industry rested, on one hand, on a regulatory framework that guaranteed accounting benefits in return for some restrictions on the nature of the investments, and, on the other, on fund managers' responsibility, awareness in dealing with companies, and individuals' savings. This balance, institutional and cultural, showed all its fault lines in the months leading up to the 2008 crisis, when the fund managers had a real opportunity to invest in securities with high returns, such as *commercial papers* issued by troubled and high-risk financial companies. Curiously, the first to fall into this trap was RPF's founder, Bruce Bent. After spending his professional life warning about investing in *commercial papers*, Bent decided to invest RPF's portfolio in securities issued by companies like Bear Sterns, Dexia Bank and Lehman Brothers, known to the market for their high-risk exposure. This was a decision RPF and its shareholders would pay for when the crisis exploded.

Studying this case in the light of the MacIntyrean scheme of 'goods-virtues-practices-institutions' allows identification of those elements to be retained to avoid any similar future crisis. In fact, an investment decision driven first and foremost by high returns, even though not prohibited by the law, may represent, according to the MacIntyrean vocabulary, an agent's decision to focus on the 'external' goods in preference to 'internal' ones.

This choice, as a result of the agent's inability to withstand market pressure and manifests a lack of virtue, involved the corruption of the money-market fund's 'practice'. The practice was cash-management aimed primarily at preserving shareholder capital. The corruption of the 'practice' caused the degradation of the institution and, eventually, of the system within which the institution inhabits. This chain of events easily shows up in a strongly intertwined system such as the financial one. In the RPF case, the domino effect starting from the failure of RPF and then to the crisis of the entire money-market sector of the US market, was arrested only by the intervention of the Federal Reserve and the US Treasury.

In this context the framework theorized by MacIntyre, whose application in the business world owes much to the work of Moore (2002; 2017), is a useful tool to avoid similar crises in the future given its ability to bind: i) the 'internal good' of the 'practice' of the money market fund, ii) the integrity of the agent's narrative, namely that of Bruce Bent, and iii) the contribution of the 'practice' to the good of the society as a whole or the threat that may derive from its corruption.

This latter point emphasizes a significant feature of MacIntyre's project: the bridge between the 'practice' and its contribution to the good of the community, also defined as 'common good'.

Catholic Social Teaching (CST)

Securitization

The concept of the common good has been nurtured in particular within Catholic Social Teaching (CST), which is our third source of reference for virtue ethics. This usually refers to that corpus of encyclicals, pastoral letters, conciliar and other official documents with a social focus. CST's beginning is generally traced back to the encyclical *Rerum Novarum* by Pope Leo XIII (1891). The relevance of CST's main principles, for instance that of human dignity, solidarity and subsidiarity lies in the fact that, as indicated by Rajan (2011: 126) and Zingales (2015), the financial sector lacks an internal criterion by which to judge when a financial product is actually benefiting society rather than threatening it. The *efficiency* criterion, often used in neo-liberal market economics, is configured more as a second order criterion, as it does not guarantee a view of the *end* of an instrument but rather it concerns *how* a certain product behaves.

Let's consider, for instance, the case of the *securitization* made famous by the financial crisis of 2008. This innovation actually brought a Copernican revolution in the banking system, signing the passage from an Originate to Hold model, to a Originate to Distribute model. In the Originate to Hold model the issuer retains loans on its balance sheet. Due to capital availability the issuer faces a restriction on the amount of loans that can be issued. In contrast, the Originate to Distribute model involves the pooling and tranching of structured collateralized securities – the now infamous, *collateralized debt obligations* (CDOs). These debt-backed securities were eventually sold in the global financial markets, releasing the issuers from any restriction.

If *securitization* provided a real benefit to borrowers, extending the possibility to get a mortgage and making more complete the markets, its process gradually shifted into a mechanism so opaque (the CDOs were followed by the CDO^2 and CDO^3) that the initial risk spreading turned into a risk misallocation. Complex securities were sold without a true comprehension of how they actually functioned. In this context, the respect of the human dignity recalls that behind any transaction there is a human counterpart who has the right to complete and correct information to make a free decision. Analogously, the principle of subsidiarity, which in the business world is linked to the freedom of taking risks, is useful to distinguish the difference between a securitization process that helps people in managing risks, and the selling of ultra complex securities that disregards the sophistication level of the investors.

To conclude, the tradition of virtue ethics in relation to Aristotle, MacIntyre and the CST, constitutes a *unicum* which, from a philosophical perspective, allows us to explain the dynamic by which finance can contribute to society as well as threaten it.

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