



finance & bien commun common good

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CRISE OU CATA...LYSE ?

FEATURE ARTICLES

- La finance trahit-elle le capitalisme ? *Marc Chesney*
- Minsky's 'Cushions of Safety', Systemic Risk and the Crisis *Jan Kregel*
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 - Trust, Honesty and Ethics in Business *Tamar Frankel*
- La représentation du risque : une faute morale collective ? *Christian Walter*

NEWS MONITOR

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- De la spéculation pour soi au souci des autres *Fabrizio Sabelli*

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A Call for Ethical Expertise in Financial Markets

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Les deux fonctions
fondamentales des
marchés financiers
sont l'allocation des
capitaux et le transfert
du risque.

Un investisseur
classique acquiert des
actions parce qu'il est
intéressé par une entre-
prise ou un secteur en
particulier.

Les propriétaires
d'actifs financiers sont
plutôt intéressés à
participer à la création
de valeur économique
en général dans une
perspective de long
terme.

For many people, financial markets are equal to immorality. During the past couple of years, ruthless managers and brokers took their chances, caring for nothing but their own quick profit. They have been pointed out as being responsible for the destabilization of markets, of local and global corporations, and even of the world economy: it is the result of their excessive race for money. While they were making a fortune, the losses went to the State and the honest taxpayers. Cases like the crash of Madoff's \$50 billion snowball system show it: even criminals took advantage of the opportunities of modern financial systems.

Certainly it is not that simple. So - from an ethical perspective - what are the real reasons of this crisis?

Roles and functions of financial markets

Financial markets can be understood as complex systems with two core functions: allocation of financial capital and risk transfer.

Under normal conditions, financial markets offer the opportunity for financial capital to participate in the creation of economic value e.g. through assets like stock shares. But shares are just one possibility: there

are countless ways to participate in - and profit from - value creation through financial markets. Therefore, I'd like to introduce a threefold analytical distinction in types of investor:

- Classical investors: a classical investor owns stock shares because he or she is interested in a particular company or a particular industry. Stock shares, traded on exchange markets, allocate capital towards successful companies and - at the same time - transfer entrepreneurial risk to the owner of the capital.

- Asset owners: an investor could also be looked at as an 'asset owner', who is not interested in owning shares of a particular corporation, but rather in participating in economic value creation in general and from a long-term perspective. In this case, through financial markets, he or she can own a diversified portfolio of assets and hopefully increase the value of his or her funds. Pension funds for example would typically be used by asset owners.

- Speculators: a speculator is neither interested in particular companies, nor in economic development in general or in the long run. He is betting on specific, single assets or on entire markets to go up or down, it doesn't matter which way. He gains

Le spéculateur va parier sur les mouvements boursiers - ascendants ou descendants, peu importe - d'actifs spécifiques ou de marchés entiers. Ses gains sont liés à la justesse de ses anticipations.

Le fait que les marchés forts puissent absorber les pertes d'autres marchés signifie que la défaillance d'un marché peut aussi avoir des répercussions plus larges.

Les opportunités sur les marchés financiers ont commencé à saper les fondations de ces mêmes marchés; un développement qui était tout sauf durable.

if his expectations were right and he loses if they were wrong.

Speculators maintain the liquidity of markets; and as they win or lose, as a side effect, they generate information on asset prices, which is important for the functioning of the system: speculation creates value for all market participants and makes markets work more efficiently. So, ideally, on financial markets, funds - whether investment, long-term asset or speculative capital - are allocated to the risks they are able to bear: long-term or short-term, high or low risk.

However, markets have never worked completely as they would in a model: e.g. pension funds, (which would normally be typical asset holders) can act as speculators, in order to hedge their risks. Speculators can mask themselves as investors and take over industrial or real estate assets, just to sell them after a short period of time and make a quick profit. Somehow it is almost impossible to say who is an investor, an asset owner or even a speculator.

Financial markets undermined their own foundations

Markets are interconnected in complex and manifold ways. Funds - as well as risks - cross the borders between the real economy, the portfolios of asset owners and the screen figures of speculators. This is not a problem; it could even be an advantage, as long as growing markets

can absorb losses. In fact, on the one hand, merely speculative trade can absorb a real economy loss if the capital involved is capable of bearing the risk it took; on the other hand, strong economic development can absorb speculative losses because new, value-creating opportunities open up to speculators just as to investors.

However, the fact that strong markets on one side can absorb the losses of markets on another side implies that a faltering or a decreasing market could trigger problems on other markets too: speculative losses can destroy real economic value; a slight decrease in GDP growth can trigger alarmism on speculative markets.

Moreover, market actors are anything but well informed. Not only the markets, but also specific products are often highly complex. Nobody could ever imagine all the different scenarii that might possibly evolve from aggregated developments and cascades of cause and consequence. Actors on financial markets normally take decisions on the basis of incomplete and even highly insufficient information.

In recent years financial markets have offered a wealth of opportunities to many people: derivatives, hedge funds, 'absolute return' products, many things appeared to be possible. There were few sceptics or even critics. But many were those who thought they had things under control. We now know better: many people didn't even know what they

Ces développements ont été renforcés par le fait que beaucoup de transactions sur les marchés financiers étaient réalisées sur marge, donc financées par des tiers.

Le capital spéculatif à effet de levier ne crée pas de valeur à travers l'information, ni n'assume de risques économiques réels. Au contraire, il ne fait rien d'autre que créer de nouveaux risques systémiques, auparavant inexistantes.

Ces risques imaginaires sont transférés vers des nouvelles opérations spéculatives : d'où un effet d'entraînement.

Ceux qui se refusent à financer leurs transactions spéculatives avec des fonds empruntés gagnent moins que leurs concurrents.

were doing and hardly anyone saw the systemic risks that had started to develop.

The opportunities of the financial markets started to undermine the foundations of the markets themselves; a development that was anything but sustainable.

The creation of new risks

The above-mentioned developments were reinforced by the fact that many transactions on financial markets were leveraged, financed by a third party. This opened new business opportunities and offered the possibility of spreading risks. There is nothing wrong with this from a moral perspective. From a market participant's point of view, this is not only a tempting option, but also a reasonable way of doing business. But this shouldn't stop us from taking a macroeconomic perspective, and querying the cases where credits make or fail to make sense.

Indeed, credits do make sense, as long as they trigger gains in productivity and thus increase macroeconomic efficiency. With regard to speculation on financial markets, this means that as long as speculation creates market liquidity and thus generates information for other market participants, it makes sense: markets work more efficiently.

However, as soon as credit-financed demand for assets creates speculative bubbles, there is no more efficiency, but rather increasing confusion. The problem is that it is al-

most impossible to say when an active and attractive market turns into a bubble.

As a consequence, collective confusion is confounded with certainty and real threats increase without anyone being aware of them: speculative, leveraged capital neither creates value through information, nor does it bear real economic risks; instead it does nothing but creating new, previously nonexistent systemic risks. Those phantom-like risks are then transferred to some new, leveraged speculative capital: a feedback circle is developed. There is no new economic value, but there are new risks, paradoxically quite often produced by financial products that originally were invented to hedge risks.

From a systemic perspective, and aggregated to large sums, leveraged speculative capital doesn't carry existing or real business risks; it creates its own, which are sometimes even greater than it can bear. In a state of collective confusion this seems to work.

Immoral or amoral economy?

We would fall short of the truth by saying that this is all immoral. However, in a state of collective confusion, behaviour that puts the system at risk appears to be rational. In fact, those who wouldn't finance their speculative transactions via third parties would gain less profit than their competitors, like for example a CEO of a bank: wouldn't he

La crise que nous vivons n'est pas à l'origine la somme agrégée d'opérations immorales, mais un problème systémique qui se situe à des niveaux différents, qui trouve ses racines dans la prétendue amoralité du système économique.

Le fait est que dans un cadre considéré comme « amoral » les opérateurs financiers ont agi raisonnablement.

Une sphère amonale permet non seulement le développement des risques systémiques, mais accorde aussi un avantage systémique à l'opportunisme et à l'immoralité.

La structure du marché doit être conçue de façon à susciter la prise en compte de l'intérêt collectif.

be letting down his shareholders and cause them to walk away? For him, it is nothing but reasonable to reduce equity to the legal minimum and leverage the bank's own business with the free capital. The crisis we are experiencing is not primarily the sum of aggregated immorality, but a systemic problem at different levels, which has its roots in the so-called amorality of the economic system.

From an ethical perspective it is not arguable to declare economy in general - and markets in particular - an amoral sphere. By blanking out moral aspects from economic behaviour, the seeds for systemic risks are sown: market actors won't be in possession of sufficient information to be able to take decisions or to take responsibility for their actions, because they won't even consider the moral dimensions of their decisions. In a supposedly amoral sphere, the fact that actors are not taking any moral responsibility converges with some sort of a diffuse responsibility of the system.

This is somewhat the case of the current crisis: many agents may have acted reasonably, and we could even assume they all did; and yet their aggregated decisions resulted in a state that no one could reasonably have desired. No one wants the result, but everyone was involved in producing it. By acting in a - supposedly - amoral framework, all actors collectively seem to be the originators of a result that is undesirable from an economic as well as from an ethical perspective.

And yet everyone claims to have acted in a sensible way!

What can we learn from this? The undesirable result is not caused by the single agents and not even by the sum of their doings: it is caused by the functional relations of the supposedly amoral system they formed.

Increase the moral point of view

Many managers or brokers may have acted in an immoral way, but that's not the point: their moral attitude or even their moral behaviour didn't matter. The fact is that within a framework that had been declared as 'amoral', they acted reasonably. At the end of the day, those who wouldn't have complied with the logic of the framework would have been the losers. By definition an 'amoral' system denies that ethics matter, and it even denies that the system itself rests on moral foundations, on aspects such as trust and the acceptance of overall responsibility.

An amoral sphere not only allow systemic risks to evolve, it also attributes a systemic advantage to opportunism and immorality. Therefore financial markets should not be an amoral sphere. The moral point of view has to be taken into account, in order to prevent the aggregated rational acts of market participants from undermining the foundations of the markets themselves. The market framework has to be shaped in a way that sets incentives to take responsibility for the whole.

Les managers qui ne se concentrent pas totalement sur la rentabilité à court-terme sont décrédibilisés.

Les banques, et l'industrie financière tout entière, représentent la base institutionnelle des marchés financiers. Les voir en premier lieu comme des pourvoyeurs de revenus pour des actionnaires anonymes est une erreur conceptuelle.

L'actionnaire doit s'intéresser à la création de valeur économique durable, ce qui veut dire réaliser des profits sans compromettre la viabilité économique à long terme.

With regard to institutions, a parallel can be made with the above-mentioned problem of the 'diffuse responsibility of the system'.

The morality of institutions

The French term 'Société Anonyme' stands as a metaphor: the 'Société Anonyme' is an institution that allows those involved to remain anonymous - although they are the owners! Anonymous actors are neither moral nor immoral. They are amoral by definition. Anonymous responsibility is impossible: anonymous owners are outside the question of good and bad. So who are they, if they don't have any moral identity? In the case of stockholders, they are perceived as *homini oeconomici*, interested in nothing but in increasing profits. Strong belief in this model produces a self fulfilling prophecy: the shareholder culture of the past couple of years has led to the fact that even slightly slower growth of profits could endanger stock prices.

Managers who fail to fully concentrate on increasing short-term return on equity would be looked on as losers. For example, for bankers it is rational - they even consider it to be their responsibility - to achieve short-term profits by keeping down the equity rate and leveraging the company's own business through debt. Incentive systems used to reinforce this effect. We now know the consequences. A sharp focus on shareholder value and narrow busi-

ness logic in banking governance makes people forget about the real value of banks.

This value can only be estimated from a macroeconomic perspective. Banks, the financial industry as a whole, are the institutional platforms for financial markets. If they are primarily seen as creators of return on equity for anonymous shareholders, this is a fatal misperception. Banks create value by allocating capital to economic risk. From a macroeconomic perspective, this is their contribution to the increase of the overall economic performance, and not primarily the creation of shareholder value. Banks as indebted speculators are systemic risks, potential epicentres, and a threat to economic efficiency and performance.

If speculative losses materialise in a context of stagnating or decreasing markets, banks destroy capital, endanger their ability to carry further risk, destroy trust, and finally become a burden to the state and the taxpayer. Can this be the interest of shareholders?

Shareholder responsibility

Shareholders need to develop a sense of the creation of sustainable economic value, which implies making profits without compromising future economic potential. Shareholders should walk away from companies that make short-term profit at the cost of future potential, and look for those that equate business with a creation of long-term sustainable value. Institutional as-

L'actionnaire devrait également se tenir à l'écart d'entreprises axées sur le profit à court terme, et privilégier celles qui, au contraire, concilient les affaires avec la création durable de valeur.

La complexité des marchés et des produits financiers modernes augmente le risque de transactions caractérisées par une asymétrie d'information donnant lieu à des abus.

Les top managers doivent être capables d'instaurer la confiance, au lieu de la détruire.

Toutefois, vu la complexité du système économique, il n'est pas suffisant de se comporter correctement, de faire les choses en toute conscience en se basant sur ses intuitions morales.

set holders like pension funds and insurance companies should recognise the importance of their role in this respect. Even though it is tempting, and even if it seems to be reasonable to show a good quarterly or annual performance, they should recognise that their real fiduciary responsibility is to contribute to long-term creation of sustainable economic value. They can achieve this by investing in companies that do not maximise their present profits at the cost of the future, but take sustainable responsibility for the common good.

In short, financial institutions, market platforms, banks, insurance companies and, most importantly pension funds should be developed in a way that corresponds to their macroeconomic role. Banks should not be obliged to maximise their short-term profits. They should produce sustainable profits that do not compromise future economic potential, either of the banks themselves, of other companies, or the State. The 'Société Anonyme' should be shaped in a way that creates incentives and enables shareholders to invest in sustainable companies and to take responsibility for their long-term success.

Institutional shareholders should stop looking to short-term performance and take a long-term systemic view. They should be able to make their long-term future investments in a safe and stable environment that allows a maximum of freedom of decision and action.

As explained above, amoral spheres attribute systemic advantages to immorality. This leads to a serious ethical problem concerning individual behaviour.

What about individuals?

The complexity of financial markets and modern financial products increases the likeliness that many transactions may be characterised by asymmetries of information that is liable to abuse. Lying, cheating, and not telling the whole truth are behaviours that undermine the foundations of well functioning markets. Immoral market participants can hide under the magic cape of amorality and transfer their risks to those who are not aware of them.

Let us consider the trigger of the current crisis, the US real estate market: estate agents and real estate loans sold dreams to people who couldn't really afford them. Bankers saw non-performing real estate loans and structured them in order to make them look like business opportunities. Top managers hid behind insufficient governance structures in order to conceal the true situation. And incentive systems even encouraged them to do so: private opportunities for profit could be maximised, while risks remained with the company, the shareholders, the employees and the State.

The ongoing debate about compensation schemes, bonuses and salaries just touches on one aspect of the whole problem. But it clearly shows the expectations of the pub-

La compétence éthique, la capacité de réfléchir aux aspects moraux des actions des individus et des institutions, de se tenir à une ligne de conduite cohérente et, enfin, de prendre des décisions qui obéissent à une rationalité aussi bien éthique qu'économique, tout cela est nécessaire !

lic as far as the moral qualities of top managers are concerned. They should build trust, and not destroy it. They should show that their motivation to do their job is not the incentive scheme, but the will to achieve sustainable success for the company and to take responsibility for customers, employees and the common good.

The most valuable asset of a bank is trust: trust of existing and potential customers; trust of business partners and of the public at large. The value of trust can never be seen more clearly than when this trust is lost.

Therefore, business leaders, particularly in the financial industry, should meet the highest expectations when it comes to character and ethical competence. They need to be able to create trust through personal integrity. But in the view of the complexity of the economic system, it is not enough to be decent, to work conscientiously and use moral intuition. Ethical competence, the ability to reflect on moral aspects of individual and institutional behaviour, to develop respect and ultimately,

to take decisions that comply with ethical, as well as with economical rationality, is required!

Reaction to the crisis

The present crisis creates much moral indignation. The reaction must be the call for greater ethical competence.

Firstly, the ethical foundations of markets must be perceived and shaped to conform to the overarching international, constitutional and legal frameworks.

Institutions must also be conceived in a way that provides advantages to those people who are willing and able to take sustainable responsibility for the common good.

Finally, business leaders should be trained and selected to not be naïve or think they exist and act in an amoral sphere. They need not only business but also ethical skills. They should have the ability to decide, to behave, and to shape institutions in a way that creates trust as well as long-term economic value for customers, stakeholders and the general public. •

Last Issues / Derniers numéros

- 25 Europe: la microfinance se fait une place
- 26 La finance joue avec le sport
- 27 Robin Cosgrove Prize. Ethics in Finance
- 28/29 L'Afrique entre traditions éthiques et attraits financiers
- 30 Can Management Survive without Values?

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