



**Schulich**  
School of Business  
York University

---

# Ethics in Finance: Still an Oxymoron?

**Sabancı University, School of Management**  
3 July 2012

**Professor Dirk Matten**  
Hewlett-Packard Chair in Corporate Social Responsibility  
Schulich School of Business  
York University

# Overview

---

- Introduction
- Situational factors on ethical decision making in finance
  - The ethics of financial markets
  - The effects of moral intensity and bureaucracy
- Market imperfections as source of ethical infraction
- Financial intermediaries and ethics
- The finance sector as driver of business ethics
  - Shareholder activism/socially responsible investment
  - Alternatives to public ownership

# Never ending scandals...

**theguardian** Your

[News](#) | [Sport](#) | [Comment](#) | [Culture](#) | [Business](#) | [Money](#) | [London 2012](#) | [Life & style](#) | [Travel](#) | [E](#)

**Business** > **Banking**

## Mervyn King tells banks: you can't go on like this

Governor's scathing attack on **industry's culture of excess** as new scandal erupts

[Share](#) 110 | [Tweet](#) 90 | [+1](#) 1 | [Email](#)

---

[Larry Elliott](#), [Jill Treanor](#) and [Nicholas Watt](#) in Brussels  
[guardian.co.uk](#), [Friday 29 June 2012](#) 23.50 BST  
[Comments \(325\)](#)

---



Mervyn King, the governor of the Bank of England, says something has gone 'very wrong' with Britain's banks that needs to be put right. Photograph: David Jones/PA

Sir [Mervyn King](#), the governor of the Bank of England, piled the pressure on the City on Friday when he said something had gone "very wrong" with Britain's banks that needed to be put right.

As [Barclays](#) and other high street banks became embroiled in a new mis-

---

**Business**

- Banking · Banking reform
- Financial Services Authority (FSA) · Mervyn King · Barclays · Libor · Interest rates · Financial sector · Bob Diamond · HSBC · Lloyds Banking Group · Royal Bank of Scotland · Regulators

---

**UK news**

---

**Politics**

---

**More on this story**



**Bank of England governor refuses to back Bob Diamond**  
Asked twice whether Bob Diamond was 'fit



Schulich  
School of Business  
York University

theguardian

News | Sport | Comment | Culture | Business | Money | London 2012

Business > Royal Bank of Scotland

## RBS chief Stephen Hester gives up bonus over computer meltdown

Stephen Hester is second bank chief executive to waive his bonus – which could have been worth up to £2.4m

Jill Treanor, City editor  
guardian.co.uk, Friday 29 June 2012 14:07 BST  
Comments (...)



# Never ending scandals...

## DealB%k

ANDREW ROSS SORKIN  
EDITOR-AT-LARGE

MERGERS & ACQUISITIONS | INVESTMENT BANKING | PRIVATE EQUITY | HEDGE

LEGAL/REGULATORY | JUNE 29, 2012, 8:16 PM | 3 Comments

## In Guilty Plea, Peter Madoff Says He Didn't Know About the Fraud

BY PETER LATTMAN AND BEN PROTESS



# Never ending scandals...



**SPIEGEL ONLINE INTERNATIONAL**

NACHRICHTEN VIDEO THEMEN FORUM ENGLISH DER SPIEGEL SPIEGEL TV ABO SHOP

Front Page | World | Europe | Germany | Business | Zeitgeist | International Forum | Newsletter

English Site > Europe > Euro Crisis > Merkel Concessions at Euro Crisis Summit Smarter than they Seem

## TOPIC Euro Crisis

Related articles, background features and opinions about this topic.

06/29/2012 [Print](#) | [E-Mail](#) | [Feedback](#)

### Merkel's Tactical Victory

#### Smart Concessions from a Seasoned Negotiator

A Commentary by *Christian Rickens*



**RELATED TOPICS**

- European Union
- Debt Crisis
- Austerity Measures
- Angela Merkel
- Francois Hollande
- Spain

**REPRINTS** [»](#)

**SPIEGEL ONLINE** Find out how you can reprint this SPIEGEL ONLINE article.

# Finance – what are we talking about

---

- Areas of finance
  - Personal finance
  - Corporate finance
  - Public finance
- Key institutions
  - Financial markets
  - Financial intermediaries

# Influences on ethical decision-making

---

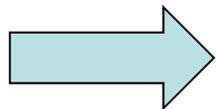
- **Situational factors** - particular features of the context that influence whether the individual will make an ethical or unethical decision
  - Work context
  - The issue itself
    - intensity
    - ethical framing
- **Individual factors** - unique characteristics of the individual making the relevant decision
  - Given at birth
  - Acquired by experience and socialisation

- **Jeremy Irons in Margin Call (2011)**
- <http://www.youtube.com/watch?v=xOO1NY6ctYU>

# The ethics of financial markets

---

- Finance as a field with what comes closest to perfect market assumption
- **Theory of egoism** - an action is morally right if the decision-maker freely decides in order to pursue either their (short-term) desires or their (long-term) interests.
  - **Adam Smith** (1793) – pursuit of individual interest morally acceptable through invisible hand of market as creates benefit for all
  - Relies on free competition & good information
  - ‘Enlightened egoism’



**Finance professionals face the most ethical environment of all sub-fields of management**

# ... but it comes at a price



## Kohlberg's model of Cognitive moral development

# Financial markets create characters of infantile morality

---

- **Actors in financial markets tend to be stuck at the preconventional level (Kohlberg level 1)**
- **Little challenge to develop**
  - **Personal values:**
    - ‘an enduring belief that a specific mode of conduct or end-state of existence is personally or socially preferable to an opposite or converse mode of conduct or end-state’ (Rokeach 1973:5)
  - **Personal integrity**
    - Defined as an adherence to moral principles or values
  - **Moral imagination**
    - Concerned with whether one has “a sense of the variety of possibilities and moral consequences of their decisions, the ability to imagine a wide range of possible issues, consequences, and solutions” (Werhane, 1998:76)

- **Margin Call - Fat cats and starting dogs**
- [http://www.youtube.com/watch?v=L5gZrgGXOco&feature=player\\_detailpage](http://www.youtube.com/watch?v=L5gZrgGXOco&feature=player_detailpage)

# Moral Intensity

---

- Jones (1991:374-8) proposes that the intensity of an issue will vary according to six factors:
  - Magnitude of consequences
  - Social consensus
  - Probability of effect
  - Temporal immediacy
  - Proximity
  - Concentration of effect

# Authority and Bureaucracy

---

## Authority

- People do what they are told to do – or what they *think* they're being told to do



## Bureaucracy

- Jackall (1988), Bauman (1989, 1993) and ten Bos (1997) argue bureaucracy has a number of negative effects on ethical decision-making
  - Suppression of moral autonomy
  - Instrumental morality
  - Distancing
  - Denial of moral status

# Crucial problem: imperfect pockets of financial markets

---

- Peculiarities of corporate ownership
  - Locus of control
  - Fragmented ownership
  - Divided functions and interests
- Core role of intermediaries
- Financial innovation creates temporary intransparency
- Deregulation & globalization

# Global financial markets

---

- **Global financial markets** are the total of all physical and virtual (electronic) places where financial titles in the broadest sense (capital, shares, currency, options, etc.) are traded worldwide
- Ethical issues raised:
  - Governance and control (Euro crisis)
  - National security and protectionism
  - Speculation (see slide on Tobin tax)
  - Unfair competition with developing countries
  - Space for illegal transactions (see slide on money laundering)

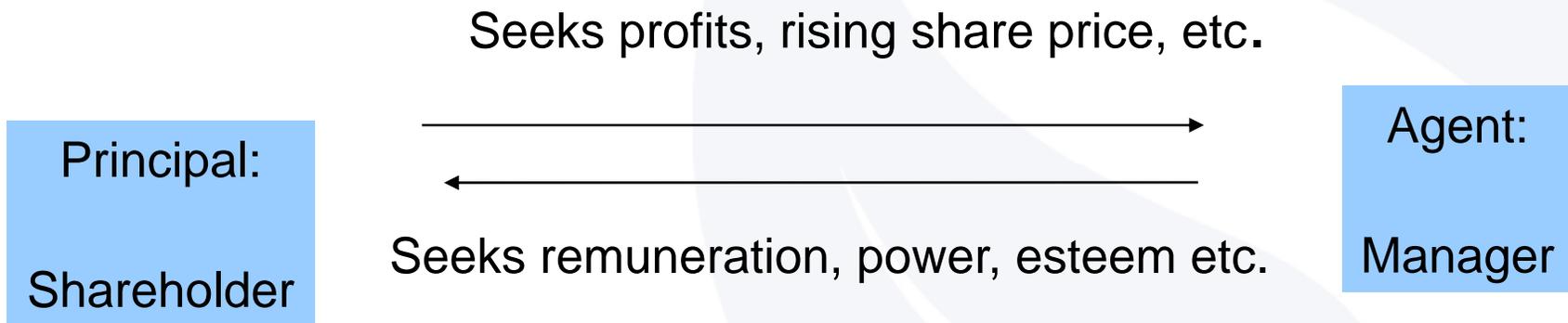
# The 'Euro crisis' – another market imperfection?

---

- 'Birth defect' of the Euro: a single currency with 17 different fiscal regimes
- Weak institutions to fail to make markets
  - Transparent
  - Efficient
- Global governance dilemma: how to bring nation states to accept transnational governance
- Markets do not work without external sanctioning mechanisms

# Core ethical conflict

---



## Features of agency relations

1. Inherent conflict of interest
2. Informational asymmetry

# Limits of agency theory

---

- Assumption about human beings
- Shareholder supremacy
- Self-fulfilling prophesy



# The role of financial markets and insider trading

---

- Speculative 'faith stocks'
  - 'dot-com' bubble (companies not made any profit but worth billions on the market)
  - Ethical issue: bonds based entirely on speculation without always fully revealing amount of uncertainty
- Insider trading
  - Insider trading occurs when securities are bought and sold on the basis of material non-public information (Moore 1990)
  - Ethical arguments (Moore, 1990)
    - Fairness
    - Misappropriation of property
    - Harm to investors and the market
    - Undermining of fiduciary relationship
  - Insider trading can erode trust in the market in the long term; hence its illegality

# The role of financial professionals and market intermediaries

---

Two crucial professions: Accountants & credit ratings agencies

- Task is to provide a ‘true and fair view of the firm – i.e. bridge informational asymmetry
- Five main problematic aspects of financial intermediary’s job:
  - Power and influence in markets
  - Conflict of interest (e.g. cross-selling)
  - Long-term relationships with clients
  - Size of the firm
  - Competition between firms (danger of corner-cutting)

# Private equity and hedge-funds

---

## Rise of private equity and hedge funds exacerbate issues around transparency and shareholder control

- **Most general concern:**

- There are no longer many obligations for public information about a company once it has been taken private

- **Hedge funds do not have to report to regulators in the same way as other investment firms**

- Don't even have to report fully to own investors
  - Suggestion is this lack of transparency hides systemic risk

# So, what about solutions?

---

- Cultural change in the finance sector: legitimizing the ethical question
  - Business education
  - Leadership
  - Institutional reform
- Regulation (imperative, soft, self-)
- New social movements
- Social innovation in the finance sector
- Alternative forms of ownership beyond capital markets

# Shareholder democracy

---

- Idea that a shareholder of a company is entitled to have a say in corporate decisions
- Supported by legal claim based on property rights
- Can shareholders be a force for wider social accountability and performance?
- Three issues to consider:
  - Scope of activities
  - Adequate information
  - Mechanism for change

# Two approaches to 'ethical' shareholding

---

|                       |                           |
|-----------------------|---------------------------|
| Stakeholder activism  | Ethical investment        |
| Single-issue focus    | Multi-issue concerns      |
| No financial concerns | Strong financial interest |
| Seeks confrontation   | Seeks engagement          |
| Seeks publicity       | Avoids publicity          |

# Shareholder activism

---

- Buy shares in company for right to speak at the AGM
  - Voice concern and challenge the company on allegedly unethical practices
  - Possibility of broad media attention by ‘disrupting’ the meeting
- Issues:
  - Gets involved with ‘the enemy’
  - Only an option for reasonably wealthy individuals



Schulich  
School of Business  
York University

# Socially responsible investment (SRI)

---

**Ethical investment** is the use of ethical, social and environmental criteria in the selection and management of investment portfolios, generally consisting of company shares



# Ethical investment

Examples of positive and negative criteria for ethical investment

---

## Negative criteria

- Alcoholic beverages production and retail
- Animal rights violation
- Child labour
- Companies producing or trading with oppressive regimes
- Environmentally hazardous products or processes
- Genetic engineering
- Nuclear power
- Poor employment practices
- Pornography
- Tobacco products
- Weapons

## Positive criteria

- Conservation and environmental protection
- Equal opportunities and ethical employment practices
- Public transport
- Inner city renovation and community development programmes
- Environmental performance
- Green technologies



# Ethical Investment

## Top 10 stocks held in SRI funds in emerging market firms, 2009

| Position | Company                                    | Industry                          |
|----------|--|-----------------------------------|
| 1.       | Petrobras ( <i>Brazil</i> )                | Oil and gas                       |
| 2.       | Samsung Electronics ( <i>South Korea</i> ) | Consumer electronics              |
| 3.       | China Mobile ( <i>China</i> )              | Mobile phone provider             |
| 4.       | Taiwan Semiconductor ( <i>Taiwan</i> )     | Electronics                       |
| 5.       | Teva ( <i>Israel</i> )                     | Pharmaceuticals                   |
| 6.       | Vale Do Rio Doce ( <i>Brazil</i> )         | Mining                            |
| 7.       | America Movil ( <i>Mexico</i> )            | Mobile phone provider             |
| 8.       | Gazprom ( <i>Russia</i> )                  | Oil and gas                       |
| 9.       | Posco ( <i>Korea</i> )                     | Steel                             |
| 10.      | Ambev ( <i>Brazil</i> )                    | Alcoholic beverages (e.g. Brahma) |

# Main concerns with SRI movement

---

- Quality of information
  - Most information provided by firms and is difficult to verify
- Dubious criteria
  - See table in previous slide
- Too inclusive
  - 90% of Fortune 500 firms are held by at least 1 SRI fund
- Strong emphasis on returns:
  - Usually, SRI fund managers screen for performance first, then select using ethical criteria
  - Firms taking longer-term perspectives and thus sacrificing short-term profitability therefore unlikely to be included

(See Vogel, 2005)

# Rethinking sustainable corporate ownership: alternative models?

---

- Government ownership:
  - Part of the landscape in many parts of the world. Resurgent in the wake of the late-2000s financial crisis (esp. banks and cars).
- Family ownership
  - Families may have longer-term goals, but may not treat stakeholders any better than MNCs
- Co-operative ownership
  - Hybrid businesses, not owned by investors or managers
  - Owned and democratically controlled by workers or customers
  - Not set up to make profit but to meet the needs of members
  - Spanish Mondragon co-operative has made a striking contribution to sustainability while staying highly profitable

# Summary

---

- Principal-agent relationship between managers and shareholders
- Divergent interests and unequal distribution of information institutionalises some fundamental ethical conflicts in governance
- Shareholders have considerable opportunities to use their power over supply to influence corporations to behave more ethically
- Shareholders can play a role in driving corporations towards enhanced sustainability by their investment decisions at the stock market