Banking, ethics and good principles

Gert Wehinger, OECD Directorate for Financial and Enterprise Affairs

Whether you blame poor regulation, sloppy governance, greed or bad luck, banks were frontline culprits in causing the crisis. Governments have been working on reforms to fix the financial sector and improve governance, but a lot more work remains to be done. Some OECD principles can help.

Has banking become cleaner, more honest and more reliable since the crisis struck in 2008? Results from a survey of bank employees last year give little encouragement: at least one out of six respondents would be prepared to break the law with a little insider trading if it earned them US$10 million; a quarter of them have witnessed or have first-hand knowledge of misconduct; and nearly a third of them are convinced that getting ahead in banking requires unethical, and even illegal, conduct.

Such statistics were typical of the hubristic banking culture in the years prior to the 2008 crisis, but unfortunately they still apply today.

They come from a 2012 survey, conducted in the US and the UK by Labaton Sucharow, a US legal firm which advocates for SEC (US Securities and Exchange Commission) whistleblowers. They show that despite reforms like the Dodd-Frank Act in the US–the biggest overhaul of the financial system since the Great Depression–or the Independent Banking Commission in the UK, the depth and sweep of misconduct remains astonishing.

There have been serious scandals too, such as when traders from 20 banks across three continents colluded to manipulate inter-bank lending rates–so-called LIBOR rates that determine what millions of people pay on their mortgages and the interest they receive on their savings. These events have undermined the already low confidence in the sector, and in the way banks operate and are being regulated and supervised. In fact, as pointed out by a participant at a recent OECD financial roundtable organised to discuss the issues, too many actions by the financial sector have been destructive, even cynical, leading to negative returns for pension funds, misallocation of resources, and scandals.

The public anger and cynicism that now afflict banking were reflected in an editorial published by *The New York Times* in March 2012. The piece, written by Greg Smith, a vice president at Goldman Sachs who resigned the day the editorial was published, accused the firm of denigrating its clients and even disregarding their interests. He wrote that the quickest way to become a leader at Goldman Sachs was to persuade clients "to invest in the stocks or other products that we are trying to get rid of because they are not seen as having a lot of potential profit".

The embittered editorial was tweeted and blogged around the world. Though Goldman's bosses protested, saying Mr Smith was just one vice president out of 12,000, few other people rushed to Goldman's defence.

Has anything been done to restore trust in banking in the aftermath of the crisis? To

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be sure, many banks and their authorities have tried to reduce their exposure to risk by constantly deleveraging assets, restraining "shadow banking" activities, sharpening up on their risk modelling, and focusing on strengthening their home markets. Some countries continued to push for a clearer separation between a bank's retail and investment activities, putting retail banks safely back on Main Street and away from the dangers of investment banking. But defenders of universal banking say separating activities does nothing to check sloppy management and reckless risk-taking, and believe the answer is in better price signals and risk modelling.

Several governments are going beyond the new Basel III proposals to increase banks' capital and liquidity requirements in an internationally coordinated fashion, by adopting tougher, more binding, capital regulations, in particular with a view to improving banks' risk management. Efforts are also underway to reduce the threat of "too big to fail".

Others have undertaken initiatives such as the SEC whistleblower programme in the US to encourage people to report wrongdoing by offering them financial incentives and protection. But while 94% of respondents to the Labaton Sucharow survey said they would report wrongdoing under the programme, only 44% knew of its existence.

In the euro area but also beyond it, governments have ring-fenced their banks to prevent contagion and focus on home markets. But this has dammed up the cross-border flow of healthy capital into countries where liquidity is scarce, which can hardly be conducive to a recovery. At the beginning of the crisis, cross-border flows acted as a stabilising force; without that cash, banks clamped down on lending, further weakening the system.

Amends have been made, but in light of persistent and major financial scandals there is a clear sense that current banking models remain inadequate. An entirely new approach is needed if trust is to be restored. Take pay and compensation. Despite some moves by regulators and even the industry itself to improve the situation, most people continue to feel that many bankers are unfairly and excessively rewarded, but seem exempt from appropriate penalties. The logic that bank managers can be rewarded large bonuses in bad times as well as good times, or reap rewards during a credit crunch, seems unfair, just as it seems unfair for the financial sector to be able to privatise economic gains but socialise any losses, as it has done with the big bank bailouts that occurred in response to the crisis.

Although regulators have concentrated on making the financial sector more transparent and efficient for those who use it, they have paid little attention to improving it for the benefit of society as a whole. Indeed, the social function of banking remains in question.

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Many observers agree that policymakers and regulators need to evaluate financial markets according to real outcomes, such as access, safety and resilience, fairness, performance, accountability and trust. Indeed, the OECD has long stressed that policymakers must understand how market failures at the institutional level reverberate down the supply chain to ordinary financial users.

This is particularly true of banking. It is hard to believe that at one time, the financial sector played a relatively minor role in our economies. Financial companies were not even listed on the Dow Jones Industrial Average until 1982. In the US, for example, the sector accounted for just 4% of GDP in the affluent 1960s. By the time the crisis hit, it had doubled to 8%. But that's just the sector: entire economies now rely on the health of banking. Indeed, this poses the question of whether banks should be likened to–and treated as–basic utilities, such as water or electricity.

People's trust is essential for financial markets, and our systems, to work. Banks are the caretakers of the financial system we all rely on, which is a responsibility that cannot be underestimated. With this in mind, in 2010, the OECD, working with G20 members and the Financial Stability Board, developed the High-Level Principles on Financial Consumer Protection, which were subsequently adopted as a recommendation in July 2012. The principles aim to improve the transparency, disclosure, and responsible business conduct of financial service providers, and to provide financial users with a means of redress should they be the victims of misconduct. Restoring trust will be unachievable unless consumers and investors feel secure, and it is now up to governments and bank authorities to see that the principles are adopted and acted upon. The principles could help them stay ahead of developments and prevent a crisis from starting in the first place.

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