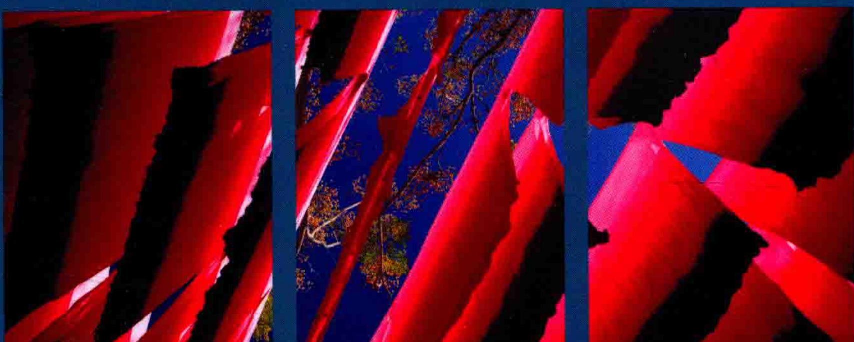
PALGRAVE MACMILLAN STUDIES IN BANKING AND FINANCIAL INSTITUTIONS
SERIES EDITOR: PHILIP MOLYNEUX

Ethics in Banking

The Role of Moral Values and Judgements in Finance



Jes Villa

Ethics in Banking

The Role of Moral Values and Judgements in Finance

Jes Villa

palgrave
macmillan

First published 2015 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN: 978–1–137–34340–6

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

Ethics in Banking

Palgrave Macmillan Studies in Banking and Financial Institutions

Series Editor: **Professor Philip Molyneux**

The Palgrave Macmillan Studies in Banking and Financial Institutions are international in orientation and include studies of banking within particular countries or regions and studies of particular themes, such as corporate banking, risk management, mergers and acquisition. The books' focus is on research and practice, and they include up-to-date and innovative studies on contemporary topics in banking that will have global impact and influence.

Titles include:

Dimitrios D. Thomakos, Platon Monokroussos and Konstantinos I. Nikolopoulos *(editors)*
A FINANCIAL CRISIS MANUAL
Reflections and the Road Ahead

Elena Beccalli and Federica Poli *(editors)*
BANK RISK, GOVERNANCE AND REGULATION
LENDING, INVESTMENTS AND THE FINANCIAL CRISIS

Domenico Siclari *(editor)*
ITALIAN BANKING AND FINANCIAL LAW
Supervisory Authorities and Supervision
Intermediaries and Markets
Crisis Management Procedures, Sanctions, Alternative Dispute Resolution Systems and Tax Rules

Dr. Fayaz Ahmad Lone
ISLAMIC FINANCE
Its Objectives and Achievements

Valerio Lemma
THE SHADOW BANKING SYSTEM
Creating Transparency in the Financial Markets

Imad A. Moosa
GOOD REGULATION, BAD REGULATION

Elisa Menicucci
FAIR VALUE ACCOUNTING
Key Issues Arising from the Financial Crisis

Anna Omarini
RETAIL BANKING
Business Transformation and Competitive Strategies for the Future

Yomi Makanjuola
BANKING REFORM IN NIGERIA FOLLOWING THE 2009 FINANCIAL CRISIS

Ted Lindblom, Stefan Sjogren and Magnus Willeson (*editors*)
GOVERNANCE, REGULATION AND BANK STABILITY
FINANCIAL SYSTEMS, MARKETS AND INSTITUTIONAL CHANGES

Gianluca Mattarocci
ANOMALIES IN THE EUROPEAN REITS MARKET
Evidence from Calendar Effects

Joseph Falzon (*editor*)
BANK PERFORMANCE, RISK AND SECURITIZATION
BANK STABILITY, SOVEREIGN DEBT AND DERIVATIVES

Josanco Floreani and Maurizio Polato
THE ECONOMICS OF THE GLOBAL STOCK EXCHANGE INDUSTRY

Rym Ayadi and Sami Mouley
MONETARY POLICIES, BANKING SYSTEMS, REGULATION AND GROWTH IN THE SOUTHERN MEDITERRANEAN

Gabriel Tortella, Ruiz García and Luis José
SPANISH MONEY AND BANKING
A History

Caner Bakir
BANK BEHAVIOR AND RESILIENCE

Jill M. Hendrickson
FINANCIAL CRISIS
The United States in the Early Twenty-First Century

Dimitris N. Chorafas
HOUSEHOLD FINANCE
Adrift in a Sea of Red Ink

Palgrave Macmillan Studies in Banking and Financial Institutions

Series Standing Order ISBN: 978–1–403–94872–4

(*outside North America only*)

You can receive future titles in this series as they are published by placing a standing order. Please contact your bookseller or, in case of difficulty, write to us at the address below with your name and address, the title of the series and the ISBN quoted above.

Customer Services Department, Macmillan Distribution Ltd, Houndmills, Basingstoke, Hampshire RG21 6XS, England

---

Prologue

After graduate school I embarked on a career in international banking that would soon evolve into a dynamic involvement in various facets of investment banking – venture capital, loan syndications, project finance and culminating in private equity. Those were exhilarating days of constant deal making and raising vast sums of money for clients. However, during the private equity phase, I frequently experienced undeniable conflicts of interest with certain board members from my controlling shareholder who would wittingly propose a course of action that suited their interests rather than those of the fund I was managing. These episodes would lead me to look into the role of ethics in banking.

Following suggestions from some respected philosophers that I investigate contemporary banking practices, I designed my empirical research on selected banks. A short time after commencing my research, the symptoms of the looming sub-prime crisis started to surface, but few observers identified it. When I attended the 2007 annual meeting in Philadelphia of the Society for Business Ethics, there were numerous professional business ethicists, several of whom came from leading financial institutions, yet there was no mention whatsoever of the emerging financial crisis or the underlying ethical factors. That was the reason I resolved to devote sections of my book to this calamity.

Acknowledgements

This book is dedicated to my wife, Joy, whose loving encouragement has enabled me to reflect and write about the critical role of ethics in the world of finance.

I am grateful to Professors Jeff Malpas (University of Tasmania) and Andrew Brennan (LaTrobe University) for initially suggesting that I focus on ethical conduct in banks, and to Professor Dr Wilhelm Vossenkuhl of Ludwig-Maximilians-Universität in Munich for his advice and comments. Special thanks go to all the individuals, financial institutions and regulators in Hong Kong and Australia for their participation in my empirical research, and to Vernon Moore and John McCleod for their assistance therewith.

I am thankful to my daughter, Giselle Villa-Hansen for her assistance in merging my documents and preparing them for turn-over to production, and to Mariel Kierulf Asiddao for her great help on indexing. I thank my publisher, Palgrave Macmillan, and especially Aimee Dibbens, commissioning editor, Grace Jackson, editorial assistant, and Joshua Evans, copy editor, for their patience and support. There are many others not mentioned to whom I owe my gratitude for their contribution.

Contents

Part I

Approaching Banking from a Philosophical Perspective

1
Global Credit Crisis

Apocalypse

The credit crunch that had first manifested itself in August 2007 was accelerating briskly during the summer months in the northern hemisphere, though much of the population outside mainstream finance in America and England was oblivious to this ominous tidal event. By September 2007 the US Federal Reserve Bank had started to slash interest rates so dramatically that economists expressed concern that such action might spark a downturn. The American central bank had taken this action to avert some of the harmful consequences on the economy,[1] but even then it could not stop the tidal wave. The economic indicators were worsening. The housing downturn continued to deteriorate with housing starts plummeting to a 12-year low and foreclosures doubling from the previous year. The construction industry was at its bleakest since the 1991 recession.[2]

Despite the rapidly spreading distress, bankers still had a sanguine outlook in November 2007, proclaiming circumstances would be different this time.[3] Bankers had been responsible for the circumstances that instigated the collapse of credit, but they failed to appreciate the full ramifications. Several top bankers would soon be fired, and leading financial institutions would collapse, eventually requiring government rescue. As the analyses in Chapters 6 and 7 will highlight, the roots of the troubles lay in the flawed ethos of sub-prime loans, which were characterized by irresponsible lending. Most of these loans subsequently became delinquent, and by July of 2007 the affected banks were required by regulations and accounting convention to set aside commensurate loan loss provisions. These substantially impaired their equity position and compelled them to raise funds in the capital and money markets. As in any panic-driven rush, many would be crushed along the way, while only a few banks would survive the credit squeeze.

Central banks around the world responded to this credit crisis with unprecedented interest rate cuts in order to restore liquidity in the financial markets, but the problems were the collapse of trust among banks in each other (as will be probed in Chapter 7) and the defensive reaction of banks to discontinue lending to most of their customers. Even after central banks continued to drop interest rates, banks would either not resume lending or would do so at higher interest margins to preserve profits. The cycle of trust that is so essential to banking had been ruptured.

What were the immediate and continuing repercussions? Firstly, as later chapters will show, millions of homeowners lost their homes and incurred substantial financial costs. Secondly, countless companies that could not get hold of economically viable financing were forced to cut production and employment. Many major industries would suffer economic hardship, for example, automobiles, airlines, heavy equipment, consumer goods, department stores and restaurants among others.

Paradise Lost

Despite attempts to find other scapegoats, most economists agree that the blame for the global financial crisis lies with the banks. Instead of prudent and efficient allocation of capital to corporate and retail clients, banks ignored credit standards and disbursed loans to anyone who was interested. Rather than acting as professional risk managers, banks assumed extraordinary risks and compelled unwitting customers to do the same; in the process everyone suffered financial ruin. The banking industry is tasked with facilitating the flow of funds in the global markets, but now it precipitated a dangerous obstruction.[4] Having broken down as an industry, America's financial-services companies were the earliest ones to suffer, slashing nearly half a million positions since the heights of December 2006 – more than half of them in the seven months prior to mid-May 2009. Many jobs were permanently eliminated.[5]

The financial disaster started with the asset bubbles created through excessive and irresponsible lending that inevitably had to burst. But this was a *crisis not just of money but also of confidence* because the problems had been greatly magnified through certain unique aspects of modern finance, which we will further examine in Chapter 7. These included the innovation of synthetic derivatives to create exposure to risk without actually having to own the underlying assets; the application of fair-value accounting, which compelled financial institutions to constantly evaluate assets on the basis of current market prices that could activate signals to dispose of investments, further pushing down prices, until the process became a vicious circle. The principal accelerant was excessive leverage.[6]

The amplifiers noted above could have been kept under control if banks had exercised better governance under sound ethical principles or if regulators had acted judiciously to prevent negligent bank practices. Alan Blinder, a professor of economics at Princeton and former vice chairman of the Federal Reserve, raised the same criticism and especially found fault with government regulators for allowing sub-prime loans to flourish and for their failure to contain home foreclosures.[7] This crisis is acutely severe because of the unique characteristics of banks. A special report on international banking in *The Economist* explained why banks are special. Firstly, their fundamental structure is grounded in trust. Banks are reliant on deposits and the inter-bank money market in order to extend credit to customers, and, when trust is forfeited, those funds can be demanded back more rapidly than loans they have extended. Secondly, banks are unique in that they undertake numerous transactions with each other. Thirdly and most importantly, the banking industry serves to promote the smooth operation of the economy by efficiently directing credit in order to effect productive uses of capital. The financial crisis upturned the system.[8]

After the crisis erupted in the banking sphere, it gradually spread to non-financial businesses with the onslaught of recession at the end of 2007. From that time till May 2009, America had shed 5 million jobs. It was estimated that more than 15 per cent of workers were either jobless or underemployed. The market value of listed shares in American companies tumbled 57 per cent from its high point in October 2007 to a low in March 2009, with some recovery thereafter.[9]

Since the credit squeeze had progressed to a global recession, the industry slowdown was felt in all countries. On 26 January 2009 major multinational companies that included, among others, Caterpillar, ING, Pfizer and Sprint Nextel announced several thousands of job cuts each; the International Labour Organisation issued a gloomy forecast of an upsurge in the global jobless rate to 7.1 per cent this year or 230 million people, which is a significant growth from 179 million in 2007.[10] Such large-scale unemployment is a cruel penalty on innocent victims.

In the spring of 2009 both General Motors (GM) and Chrysler, which had once been respectively the largest and the third-largest carmakers in America, were forced into bankruptcy proceedings because they were slowly haemorrhaging due to the drastic collapse of their sales. Though the fundamental reason behind the failure of both firms was inefficiency and overproduction, the immediate factors behind their demise were the higher cost of finance,[11] which was extremely difficult to obtain, and the sudden reduction of the take-home pay of American consumers. Many individuals had lost their jobs while others were constrained to embrace a more frugal lifestyle that meant either not regularly changing cars or buying cheaper fuel-efficient imports. The American car manufacturers had reacted defensively to the influx of better and more efficient Japanese cars in the 1970s by lobbying for government protection instead of responding in kind; in addition, their ill-conceived agreement on benefits with the unions saddled them with a heavy cost structure. GM's bankruptcy resulted in the loss of 14 factories, 29,000 jobs and 2400 dealerships in America;[12] it also involved the sale of the European operations.

Banks and Household Debt

Household savings have traditionally provided a strong impetus to economic growth in many countries, but conditions have changed in recent years. In the American situation, personal indebtedness rose steadily, from less than 80 per cent of disposable income in 1986 to nearly 100 per cent in 2000, and by 2007 it had climbed to 140 per cent.[13] Looking at actual numbers, the financial historian Niall Ferguson noted that by 2007 American consumer debt had soared to a record US$2.5 trillion.[14] A study entitled 'For a New Thrift: Confronting the Debt Culture' commented that the reckless debt culture trapped individuals in a morass of poverty and destroyed lives. Statistics showed that credit-card debt nearly tripled between 1989 and 2001, increasing from US$238 billion to US$692 billion; by 2008, it grew to US$937 billion.[15] The debt was in the main issued by banks, though there were also non-bank financial institutions to blame.

Debt can be a good thing because it enables people to purchase homes, buy goods that contribute to a better quality of life or embark on business ventures. But consumer credit cuts two ways. It brings convenience and expanded options, but, if its promoters are deceptive, it can encourage reckless behaviour and lead to tragedy, as the sub-prime mortgage foreclosures have excruciatingly demonstrated.[16] The mortgage loan problems will be examined in Chapter 6.

The study cited above stated that the percentage of American families with debt-service obligations in excess of 40 per cent of their income increased to 12.2 per cent in 2004. Delinquencies on household debt also rose during this period. Late fees on credit cards totalled US$17.1 billion in 2006.[17]