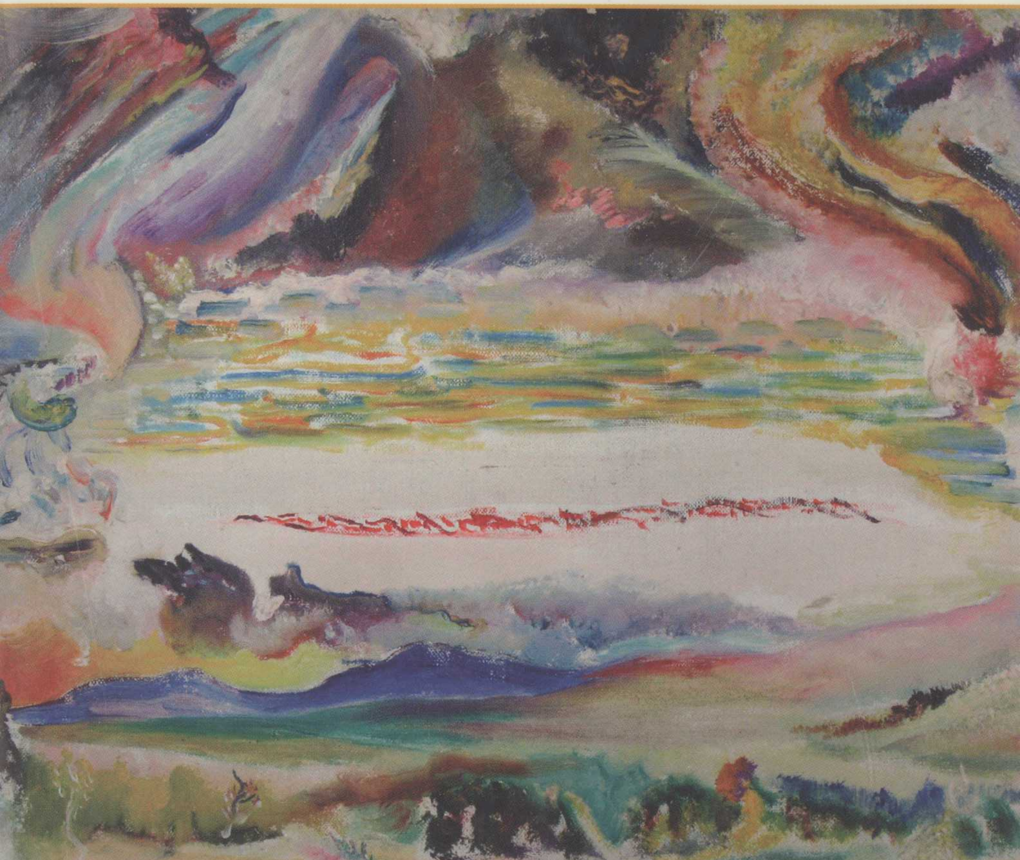
FINANCIAL ETHICS

A POSITIVIST ANALYSIS



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Preface

The target audience for this book is finance academics who are interested in exploring the connections between ethics and finance. We call the scope of all of these connections "financial ethics." The interested reader may be pleasantly surprised to find that these connections are not only pervasive but also that they continue to emerge in more explicit fashion in mainstream financial research.

To argue that the connections between ethics and finance are likely to be substantial, one need only consider the long, multifaceted relationship between economics and ethics. From its origins in moral philosophy through its struggle to develop into an independent social science, economics has had an intimate, often conflicted, relationship with ethics. This relationship continues to be viewed as relevant as indicated in the work of many eminent economists including several Nobel laureates (e.g., Gary Becker, Amartya Sen, Kenneth Arrow, James Buchanan, George Akerlof, and Joseph Stiglitz).

For its part, over the last half-century finance has developed away from management science into a subfield of economics, incorporating the canonical assumptions of economics (i.e., self-interest, rationality, and equilibrium), its methodological approach (positivism), and its techniques (e.g., mathematics, econometrics, game theory). This process of integration has become so complete that, as Gibbons (1987) observes, most finance researchers consider themselves to be "financial economists."

While the reader may prefer to distinguish between the ethical concerns of economics and the ethical concerns of finance, this distinction has become increasingly irrelevant. Thus, the concepts of moral hazard and adverse selection developed in economics, both of which contain important ethical dimensions, have found wide application in many areas of finance (e.g., agency cost theory and signaling theory).

In our view, the scope of financial ethics is vast. To make the study of this area more manageable, we somewhat arbitrarily split the field into two distinct though clearly related frameworks. We will define "normative financial ethics" as the application of moral concepts to evaluate and prescribe the conduct of economic agents. It is probably the case that most academics view financial ethics only in this dimension as evidenced by the voluminous amount of research devoted to it by none-finance scholars (such as business ethicists), but, as we will argue later, also by the vigorous opposition to the very notion of financial ethics by many financial economists. Clearly, normative financial ethics requires moral argumentation and an understanding of alternative moral systems. For reasons explained in chapter 1, research that adopts this normative approach to finance is omitted from our study.

In contrast to normative financial ethics, "positive financial ethics" is concerned only with describing, explaining, and predicting the economic consequences of moral behavior. More precisely, we consider the impact of expected moral behavior on the process of exchange and, ultimately, the determination of economic value. Although the result of such an analysis naturally leads to normative considerations, we leave this extension outside the scope of our study. Put simplistically, in the language of financial economics, it is useful to think of positive financial ethics as a study of the question "Are ethical expectations priced in transactions?"

We address this question by examining both theoretical and empirical financial economics research. Undoubtedly, many academics will question the possibility of a positive financial ethics. Yet, we will contend that moral preconceptions, or expectations, do affect economic value. The classic example of just such a case is that of Akerlof's (1970) "lemons" model in which information asymmetries may lead to market failure when agents are expected to be dishonest. The dual conditions for market failure; that is, information asymmetries and dishonesty, suggested by Akerlof's model, reflect the key link between economic value and ethics. In particular, we will argue that information asymmetries are necessary but not sufficient to produce market failure; it is also necessary that some assumption about the moral character of agents be introduced. Importantly, we assume that agents have probability distributions around the moral character of others and that the means of these distributions vary from context to context and from agent to agent. As these expectations vary, so do underlying economic values.

Befitting our perspective, we pursue a positivist methodology to examine whether and how ethical expectations influence economic value. This methodology relies exclusively on mainstream financial economics. Classifying research in this way may encourage and enable interested finance academics to consider these and other connections, because it not only avoids the normative elements but also because it is based on research and assumptions that are familiar to financial economists.

In our framework for positive financial ethics we avoid debates over what is meant by "morality" or by "economic rationality." These debates are endless and well beyond the scope of this study. Instead, we use "rough and ready conceptions." For example, by economic rationality we mean, essentially, the pursuit of narrow self-interest; by morality we mean philosophical systems such as deontology, utilitarianism, virtue, and justice that provide a basis to guide human behavior. Moreover, unless specific distinctions are made, we use the terms "economics," "finance," and "financial economics" interchangeably. Likewise, we use the terms "moral" and "ethical" interchangeably.

Perhaps needless to say, we do not attempt original research in the field of positive financial ethics. Our modest objective is to simply organize existing mainstream financial research in a way that highlights the many connections between finance and ethics. Classifying research in this way may encourage and enable interested finance academics to consider this connection. In addition, any credible positivist analysis of the proposition that finance is "value-free" would have to be firmly grounded in mainstream financial economics research; otherwise some readers would dismiss it as rhetoric.

Our organizing paradigm for positive financial ethics is the process of exchange. For clarity, we assume this process takes place between two economic agents in a nonmarket transaction.

Loosely, we examine three broad settings for this exchange. First, we examine the situation where there is an asymmetric power relationship (including both informational advantages and monopoly power) between the two agents such that the stronger agent may expropriate value from the weaker (i.e., less informed or dependent) agent. Broadly speaking, this action, whether legal or illegal, corresponds to our notion of "theft." Second, regardless whether the power relationship is symmetric or not, one agent may voluntarily and wittingly transfer value to the counterparty. This action corresponds to our notion of "altruism." Third, and related to the altruism setting, we consider a situation in which one agent (the "trustor") voluntarily and knowingly exposes himself to theft by the "trustee" in hopes of productive cooperation. In contrast to altruism, the trustor does not intend to transfer value but rather to enable mutually rewarding cooperative behavior. This notion corresponds to our definition of trust.

The notions of theft, altruism, and trust naturally encompass many related ideas. For example, theft encompasses agency costs, free riding, and expropriation. Altruism incorporates the notions of fairness and justice, among other things; while trust also incorporates the notion of fairness.

The approach to financial ethics adopted in this book will undoubtedly be provocative or even disappointing to some; and, thus, it is necessary to state at the outset what this book is about and what it is not about.

This book is not about detailing the recent scandals of financial practice or formally examining the moral validity of narrowly itself-interested agents; nor is this book intended to provide guidance for making ethically defensible financial decisions or to argue that there should be "more ethics" in finance. These are all worthy objectives for a book dealing with finance and ethics and they have been pursued by many respected scholars; particularly in the field of business ethics. Unfortunately, these contributions have typically enjoyed limited success among finance academics in both research and teaching; and finance academics have been conspicuously absent in their contributions to the field of financial ethics.

The reasons for such resistance are very likely numerous and we discuss some of them in more detail in the next chapter.

But clearly one of the most salient factors must be that financial economists, mistakenly, in my opinion, view the discipline as "scientific," "technical," or "value-free." We will argue later that this view is fundamentally flawed since even the narrowest conception of economic man (i.e., exclusively self-interested) has an explicit moral premise, that is, egoism. Moreover, the resistance to financial ethics impedes the contributions of financial economics to the resolution of important social problems, such as those of corporate governance and the adverse consequences of poorly designed regulations.

For many financial economists, the discomfort with ethical concepts is resolved by treating all such concepts as part of the ceteris paribus conditions, essentially exogenous to the financial decisions or behaviors analyzed (i.e., the agent's preferences are taken as given). Yet, there is bound to be endogeneity between the financial decision and ethical behavior. Such an assumption of endogeneity is in fact crucial to the design of incentive systems designed to alter agent behavior; but without a proper understanding of this endogeneity ex ante, the consequences of incentive systems may be completely perverse to what was expected. One need only cite the perverse incentives to lie and cheat created by performance-based compensation plans or the subversion of the net present value rule by self-interested managers who are more concerned with short-term reputation effects than long-term shareholder value.

Alternatively, other financial economists acknowledge the fact that individuals are interested in things other than monetary gain (e.g., integrity and altruism), but because money is fungible, such agents are able to trade off monetary for nonmonetary goods. In this view, there is a presumption that maximizing monetary gain is a close "first approximation" to satisfying the agent's monetary and nonmonetary preferences.

Hence, nonmonetary goods, such as ethical goods, can be treated as of second-order importance. Again, without a better understanding of the relationship between monetary and nonmonetary goods in the agent's utility function, unintended consequences can result. For example, in some cases monetary rewards may crowd out voluntary altruistic behaviors. In other cases, relationships between, for example, principals and agents may be radically altered by impersonal reward systems.

The framework just described does seem to create an impasse and, if correct, helps explain the resistance that financial economists have to introducing ethics into their research and teaching.

For such reasons alone, this book strikes a different path from other works on financial ethics. First, and most important, our framework recognizes that there are actually two fundamental challenges incorporated in the impasse posed above: 1) to demonstrate that ethics is relevant to financial analysis because it is a factor affecting valuation in exchange; and 2) that because of 1), financial economists should be motivated to invest effort in developing a better understanding of how economic value may be enhanced by ethical behavior. These two challenges fall, roughly, into two broad categories. The first challenge is an empirical question and can be addressed by what may be loosely characterized as "positive theory," while the second challenge loosely conforms to what may be called "normative theory." This distinction implies two broad dimensions to financial ethics, namely, positive financial ethics and normative financial ethics.

To illustrate the distinction we are trying to draw between the two dimensions of financial ethics, consider its analog in conventional capital market research. Risk is considered important in financial analysis because it has been shown that it affects value (this is the challenge of item [1] above). And, because risk does affect economic value, financial decisions are enriched by a better understanding of risk in its many varieties (this is the challenge of item [2]). Without first having established the relevance of risk to finance it would be difficult to attract the interest or attention of financial economists. Similarly with financial ethics. Our proposition is that progress toward incorporating normative concerns will proceed much more rapidly once the role of ethics in valuation is shown to be important.

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CHAPTER 1

Normative and Positive Approaches to Financial Ethics

1.1 A WORKING DEFINITION OF FINANCIAL ETHICS

The variety of interrelationships between finance and ethics goes under many different names such as "ethics and finance," "finance ethics," "ethical finance," and "financial ethics." The various designations undoubtedly derive at least in part from the relative emphasis the researcher wants to place on finance or ethics. Nonetheless, while we prefer the term "financial ethics" all of these variations are logically bounded at the intersection of the fields of finance and ethics possessing elements of each. Thus financial ethics is a subfield of ethics and finance.

Moreover, we will argue that this common area can be viewed from the perspective of either finance or ethics, and that the particular approach adopted is a major determinant of the type of questions examined and methodologies employed. For example, a strictly financial perspective begins with the question, are moral behaviors such as honesty rewarded? This question can be examined both theoretically and empirically.

In contrast, from an ethical perspective an analogous research question would be something like, is insider trading morally defensible? In order to answer this type of question, various theories of moral argumentation are drawn upon. Put simplistically, the financial dimension of financial ethics takes moral behaviors as givens[1] and examines their economic consequences while the ethical dimension takes financial choices as given and examines their moral status.

The interplay of these various concepts enriches the scope of financial ethics in limitless directions. Thus financial ethics may involve, from an ethical framework, the examination of such diverse issues as the fiduciary duties of managers to shareholders; the responsibility corporations have to stakeholders and society at large; to considerations of whether insider trading is moral; and whether economic agents should, if given the chance, expropriate value from others. Alternatively, from a financial perspective, financial ethics involves an objective examination of the effects of, for example, honesty on valuation, trust on efficiency, and self-interest on altruism.

In the process of examining such questions and generalizing from them, new and perhaps unexpected research areas are revealed, further expanding the field. One classic example of this is that of the effects of dishonesty and information asymmetries on the operation of markets (Akerlof 1970). A study of the resulting adverse selection problem not only

1. This does raise the obvious but difficult issue of identifying moral and immoral behaviors. Rather, at this preliminary stage, and particularly given the focus of this book, we avoid trying to define the "true" meaning of the terms. Instead, we simply adopt the commonsense interpretations of moral behavior; i.e., including notions of honesty, fairness, trust, altruism, and justice. We should also note here that there is an inescapable entangling of the two perspectives; i.e., financial and ethical, since, if certain moral behaviors correlate with superior outcomes, rational economic actors will find it in their best self-interest to pursue them.