THE ETHICS OF BANKING

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The Ethics of Banking

Conclusions from the Financial Crisis

by

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Preface

The crisis in the financial markets unexpectedly turned a spotlight on the ethical aspects of financial markets and financial institutions as a topic of considerable interest to the wider public. At the same time, it unleashed a debate about the future of capitalism which throws down the gauntlet to philosophers and economists. The financial crisis is not only a crisis of the economic system, but also a crisis of ethics for financial intermediaries, whose conduct threatened to turn the financial industry into a field of unmitigated self-enrichment. In that light, although this book was originally intended as the second edition of a volume published in 1997, in the event it was necessary to write an entirely new work.

The author is grateful to the institutions which have given him the opportunity to pursue his research: the Department of Philosophy at the Vrije Universiteit Amsterdam (VU University Amsterdam), Netherlands, where he has worked since 2004; the International Center for Economic Research, Turin, Italy, where he worked the year 2003–2004 and spent shorter research visits in 2005, 2006 and 2009; and Liberty Fund Inc., Indianapolis, Indiana, USA where he served as visiting scholar in residence for the year 2002–2003. Working with Liberty Fund gave the author a unique opportunity to become acquainted with the USA, not least by taking part in numerous Liberty Fund Conferences in all parts of the country. He hopes that his experience in America has made a beneficial contribution to the substance of this book.

Finally, the author thanks the members of the two working groups that he chairs, the Working Group for Economic Ethics and Economic Culture, German Philosophical Association, and the Working Group on Compliance and Ethics in Financial Institutions, German Business Ethics Network, for valuable discussions.

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Peter Koslowski

Introduction: Is the Finance Industry Ethically Irrelevant?

In the years before the crisis in the financial markets, banks and other financial institutions seemed to assume that nothing about their business was ethically relevant. The only principles it followed were the laws of financial mathematics. Shareholder value and return on investment were concepts that defied ethical relevance and appeared to be immanent to finance alone. The shareholder approach ousted ethical relevance to some place beyond the bounds of the financial system. The finance department of the firm maximizes shareholder value on condition that everyone in the firm abides by the firm's contracts. According to the "financial theory of the firm", the market ensures that these contracts are ethically sound since it only permits contracts that are ethically unobjectionable.

Banks in particular need not be aligned to ethical criteria like fairness because, thanks to the total rationality of market participants and "full disclosure" of contractual conditions, these standards are enforced anyway by the market.

Completely rational market participants were thus face to face with completely rational banks, and neither party could fool the other. That being the case, neither party had to ask itself whether what it was doing and contractually agreeing was ethically justifiable. Given the extraordinary rationality of market participants, the question just seemed irrelevant. What is more, some other glaringly irresponsible assumptions were made, like the belief that the market could never be wrong because, after all, it produces perfect information.

In reality, even before the financial crisis, numerous studies had shown that the market is full of hidden perils. There is contagion, the infectious over- or underestimation of stock market values; there is herding, the instinct to follow those who seem to have attracted the most followers; adverse selection, the choice not of the best but of the most loudly asserted value; moral hazard, the way that being insured against risks makes them seem less risky, and so on. Let us take herding: if the first people in a herd have rational reasons for following an opinion leader, then it can be rational to fall in behind them. For the next wave of people who follow these followers, it is already harder to say whether they are acting rationally or following people who follow other rational actors. They may equally be following other people who only followed the crowd without having rational reasons for doing so.

Following people who are following other people is a maxim that is neither rational nor ethical, because it does not question the reasons for following. But it is

frequently a maxim of the stock exchange. Never following others as a matter of principle is another maxim that is neither rational nor ethical, because it is not rational never to follow others and because the "following" syndrome is also relevant to the stock market value of securities. It can therefore be rational to follow the herd instinct. Here we see a first insight of ethics, an insight of wisdom: it is not always right to follow others, nor is it always right not to follow others. But it is always right, and a dictate of wisdom, to obtain as much information as can possibly be acquired at reasonable cost about the motives of others, and to act autonomously based on this information and one's own evaluation of the other people's behavior.

The ethics of wisdom implies skepticism about one's own and other people's knowledge, caution about exaggerations, and verification of the objective situation and the quality of the service or product. Practical wisdom or *phronesis*, as it is known in Greek – particularly Aristotelian – ethics, is not the whole of ethics but an important part of it.

How can a wise person think that creating a "structured product" like a collateralized debt obligation (CDO) by packaging together three bad mortgage loans will result in something good? How can the international banking system place so much faith in magic or financial alchemy as to make such incredible losses, when alchemy and magic have been branded as charlatanism and discredited for centuries?

An argument that is dangerous but quite clever is, of course, the argument that nobody had ever dared to create structured products in the credit industry before, so there is always a chance that it might work. We can never rule out a priori the possibility that something will work if it has never previously been attempted. Nobody could rule out the possibility that Columbus would discover India on his route westwards, even though it is located to the east of Europe. When Morgan Stanley introduced collateralized debt obligations (CDOs) for the first time in the history of the financial system in order to be able to issue more loans, why shouldn't it have worked?

Alchemy is bound up with magic, the power of the mind to exert a direct influence over matter and its aggregate states. As the philosopher Ludwig Wittgenstein put it, ironically alluding to Lewis Carroll's *Alice in Wonderland*: in magic, the mind works directly on matter. Reading aloud an especially dry poem will make the washing on the line dry especially quickly. With less dry or dull poems, it will dry more slowly. The banker puts his well-paid mind to work on the matter of the "structured products", and transmutes three relatively poor-quality loans into a single package of good credit.

An old regulation says that the farmer or grain dealer must not sell false wheat ("cheat") but true wheat. Even as a student of economic ethics, the author used to wonder what this false wheat could be; it had to be a kind of wheat with little grain in the ears. It seems easy enough to tell true wheat from cheat. Yet traditional economic ethics is full of admonitions of this nature. The butchers' guild of Cologne used to punish members who had put too much water in their wurst by forcing them to drink Rhine-water in front of all the guild members, which was naturally rather humiliating. The guild members did this because they were aware that a maker of watered-down wurst brought not just the guild but all butchers into

disrepute and undermined confidence in their product. They knew it would harm the whole trade, because customers could choose substitute products – fish pâté, fruit preserves, vegetable spread, and so on – or simply eat less meat and wurst.

It was with diluted products like collateralized debt obligations that the financial sector brought itself into disrepute. The damage done will be immense and long-lasting.[1] The customers will find substitutes for commercial bank loans. Cooperative banks, building society loans, equity interests in place of loans, saving under the mattress instead of in a bank account, loans from state banks, etc. will shrink the volume of commercial bank loans. The demutualization of the banking sector in favor of the retail banks will be reversed into remutualization in favor of the cooperative banks, mutual savings funds, and so on.

Where do ethics come into this? It is difficult for us as human beings to make an objective mental representation of reality because we are endowed with intellect, creativity and imagination. The more endowed with them we are, the more we run the risk of not recognizing what is real and mistaking our own phantasm for reality. Who would not like to be able to turn three bad things into one that is good? The Greeks called it "*Metabasis eis allo genos*", a shift to another genus, when a false conclusion was drawn from one species about another. To start with, ethics here means simply holding fast to reality as something real to stave off the temptations of our own phantasms. A great enemy of the real is value, because value comes between the real and the imaginary. What is the true value of the collateral for a loan? It might have a book value, a market value, a tax value; the multiplicity of possible valuations is an indication of how easily value can elude the valuer. An American suburb that was built only 5 years ago can plummet, within the space of a year, to the residual value of the land it is built on – and even that won't be worth much any more. When more than one-third of the houses are standing empty, nobody wants to live in the other two-thirds. The whole town begins to decay. On the other hand, we have no choice but to make valuations – it is unavoidable. A wise Swiss banker at a major bank in Basel, which was in the process of being taken over, once told the author that the most important thing he ever learned in his banking career was to view the money business in the same way as the potato business: soberly, skeptically, realistically and unostentatiously.[2]

Potatoes lack the propensity to inspire alchemy and magic, whereas money has it in spades. To deal with money without succumbing to phantasms, we have to view

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[1]Cf. on the history and chronology of the crisis in the financial markets, the bank losses and collateral damage, see the well-researched history of the crisis in: BEAT BALZLI et al.: "Der Bankraub" [The bank robbery], in: *Der Spiegel*, 17.11.2008, no. 47, pp. 44–73, online: http://www.spiegel.de/spiegel/0,1518,590656,00.html and its precise chronology in HANS-WERNER SINN: *Kasino-Kapitalismus. Wie es zur Finanzkrise kam, und was jetzt zu tun ist* [Casino capitalism. How the finance crisis happened and what to do next], Berlin (ECON) 1st edn. 2009, 2nd edn. 2009.

[2]The investment banker who sells IPOs or shares is a retailer and has the duty to sell only goods that fulfill the normal quality standards of the goods in question. Cf. LOUIS D. BRANDEIS: *Other People's Money and How the Bankers Use It* (1914), Boston, New York (Bedford/St. Martin's) 1995, p. 98: "The investment banker has the responsibility of the ordinary retailer to sell only that merchandise which is good of its kind."

it as if it were potatoes. Sobriety, skepticism and realism keep in check our own wishful overestimation of value. The result will be cautious valuation, fair pricing and realistic profit expectations. These are the sober goals of an ethics of practical wisdom for the financial system. But financial values are manifestly not potatoes. In the financial system, it is all the more difficult to heed an ethics of wisdom because the phantasm is in constant danger of inveigling its way between the financial instrument and our valuation of it, and clouding our view of reality. Hence, the financial economy is ultimately more ethically relevant and in more ethical peril than the real economy, in which the reality of the product is easier to recognize and to value.[3]

Because banks play a part in a sovereign state function – the creation of money – when they create money by lending, the financial industry is more ethically relevant than the industries of the real economy. Nevertheless, at its root – as in the real economy – is freedom of action: commercial freedom and freedom of contract. The financial economy has the right to act in and of itself, not a license to act granted by the state. The state is not the entity that gives the banks and financial institutions license to act, or withdraws it – even during and after a financial crisis. Even if a few banks made big mistakes, it is untenable to deprive all citizens of the right to found and operate banks. To say that companies are given a "social license to operate" is the wrong expression. Private autonomy and freedom of contract are not something granted by the state but principles on which the state is founded. They must therefore be unassailable by the state. The state does not grant freedom, but it guarantees it. Contractual and commercial freedom in the banking sector, then, is not something that the state exceptionally authorizes, but something that it must guarantee.

Banks may do business by accepting deposits and issuing loans as long as the business partners have the capacity to form contracts, and these are performed reliably in accordance with the terms of contract. Even in a crisis, the state has no right to prohibit or drastically curtail these contracts unless the law has clearly been broken. Instead, the opportunity to exchange banking services in a market must be guaranteed unconditionally. The state has the duty, in banking as in other sectors, to enable business interaction on the principle of private autonomy and not to inhibit or restrict it by giving inappropriate advantages to banks in state ownership.

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[3]It is interesting to note that in the discussion about money trust and financial monopolization during the anti-trust movement in the United States prior to World War I, the term "bank ethics" described the informal rule that a bank should not deal with a customer who is already doing business with another bank. Bank ethics, at that time, meant the dividing up of the market, and collusion. Cf. Brandeis (1914), p. 68: "Bankers . . . invented recently that precious rule of so-called 'Ethics', by which it is declared unprofessional to come to the financial relief of any corporation which is already the prey of another 'reputable' banker." Cf. also the Pujo Report of 1913, House of Representatives: *Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration of Control of Money and Credit, Submitted by Mr. Pujo, February 28, 1913*, Washington (Government Printing Office) 1913, p. 131: "[W]hat virtually amounts to an understanding not to compete . . . is defended as a principle of 'banking ethics'." – Needless to say, the term "ethics of banking" used in this book has nothing in common with the use of the term at the beginning of the 20th century.

Contents

Part I Foundations of Business and Finance Ethics

1 Ethical Economy, Economic Ethics, Business Ethics: Foundations of Finance Ethics 3
Purely Economic Economics Versus Ethical Economy 3
The Justification of Ethical Duties from the Nature of the Matter . . . 5
Business Ethics and the Fiduciary Duties of the Manager 9

Part II The Ethical Economy and Finance Ethics of the Markets for Credit, Capital, Corporate Control, and Derivatives

2 The Ethical Economy of the Credit Market 17
Purpose and Task of the Credit Market 17
The Purpose of the Bank for Deposit Customers, as the Bank's Creditors 18
The Purpose of the Bank for Credit Customers, as the Bank's Debtors 19
Task of the Bank: Intermediating Between Its Creditors and Debtors 19
Schuldverhältnisse: Relationships of *Schuld*, of Guilt, Debt, or Obligation. Excursus with Reference to an Equivocation in the German Language 21
Task of the Bank: Transforming Time Periods and Bearing Risk . . 23
Duties of Banks Arising from the Nature of Their Tasks to Facilitate Payments and to Enable Credit 24
Duties Arising from the Bank's Task to Facilitate Payments and Safeguard Liquid Funds 24
Duties Arising from the Task of the Bank to Transform Deposits into Loans 26

3 The Ethical Economy of the Capital Market 31
The Globalization of the Capital Market 31
Globalization Extends the Simultaneity of Space and Compresses the Non-Simultaneous Nature of Human Time 31
Globalization of the Capital Market as the Driver of Globalization of the World 32
Values and Valuations in the Capital Market 34
Which Values Should Determine the Actions of Financial Intermediaries in the Capital Market? 37
On the Ethics of Financial Consulting 39
The Tasks of the Capital Market and the Duties of the Participants in the Capital Market 40
Speculation and Finance Ethics 45
The Functions of Speculation in the Capital Market: Bearing Uncertainty and Risk as Well as Enabling the Division of Labor Between Calculation and Speculation 46

4 Insider Knowledge and Insider Trading as Central Problems of Finance Ethics 51
Insider Trading as Pseudo-Speculation and Agiotage 53
Arbitrage, Speculation, Agiotage 54
Insider Trading and the Fiduciary Relationship 55
Insider Trading as Perverse Incentive 57
Insider Trading and Short-Termism 58
Insider Trading and the Duty of Ad Hoc Publicity 58
Detrimental Effects of Insider Trading on Allocation, Distribution, and Stability 59
Experiences After the Entry into Force of the Laws Against Insider Trading in Germany 61
The Abuse of Insider Knowledge as a Form of Corruption 63
Ethical Duties of the Investor and of the Firm Quoted on the Capital Market 67

5 The Ethical Economy of the Market for Corporate Control and for Corporate Know-How 71
Hostile and Friendly Takeovers: The Finance Ethics of Corporate Control and Corporate Takeovers 71
Mergers and Acquisitions: The Capital Market as a Market for Corporate Knowledge and Know-How 74
Hostile and Friendly Takeovers and the Importance of the Global Competition Between Management Teams 76
Corporate Governance by Self-Control Through Stakeholder Consensus, and Corporate Governance by Competition from Outsiders: The German and the Anglo-American Model of Corporate Governance 77

6 The Ethical Economy of the Market for Derivatives: Trading with Values Derived from Other Values for Hedging, Speculation, and Arbitrage 83
Futures and Options: Non-Conditioned and Conditioned Forward Transactions 85
Variants of Derivatives: Futures, Options, Swaps, Structured Finance and Investment Products 86
Non-Conditioned Futures and Forwards 87
Conditioned Futures: Options 87
Swaps: A Sequence of Forwards or Options 87
Interest Rate Swaps 88
Credit-Default Swaps 88
The Collateralized Debt Obligation as a Structured Finance Product and an Instrument of Credit Enhancement 89
The Functions of Speculation in the Derivatives Market: Enabling the Division of Labor Between Hedging and Speculation . . 92

7 Interdependences Between the Financial Markets for Credit, Capital, and Derivatives, and the Challenges the Financial Markets Pose for Ethics 97
A Capital Market Within Banks in Bank-Controlled Industries: The Corporatist Model 97
The Information and Influence Asymmetry Between Banks and Manufacturing Firms: Banks as Monitors of Their Debtors' Firms 99
The Intangibility of the Merchandise Traded in Financial Markets as an Ethical Problem 100

8 The "Banking Secret", the Right to Privacy, and the Banks' Duty to Confidentiality 105
The Protection of Facts Communicated Under Confidentiality 105
Banking Secrecy, the Investigation of Tax Avoidance, Tax Evasion, Money Laundering, and the Discussion Around the Swiss "Banking Secret" 106
Banking Secrecy, the Right to Privacy, and the State: Thoughts on Political Philosophy 113
The Dualism of Private and Public, of Society and State 113
Protection of the Distinction Between Private and Public as a Consequence of Skepticism About Humans as Political Beings 115

Part III Financial Wagers, Hyper-Speculation, Financial Overstretch: The Financial Market Crisis of 2008

9 Financial Wagers, Hyper-Speculation and Shareholder Primacy . 119
Wager or Gambling: What Is Speculation? 119

The Productive or Knowledge-Increasing Financial Wager 121
The Productive and the Unproductive Wager on Derivatives 122
The Gambling Wager: Chance-Driven Betting for Fun or Good Fortune 123
The Power of Gambling over Humankind in the Epic *Mahabharata* 124
Wagers and Gambling in Cultural Theory 125
Wagers and Gambling in Civil Law and Economic History 127
The Continuum from the Wager on Corporate Strategy and the Wager on Technological Development to the Gambling Wager: The Difference Between the Value-Creating and the Non-Value-Creating Wager 129
The Functional and the Dysfunctional Extent of Financial Wagers on Derivatives 130
The Principle of Shareholder Primacy and Hyper-Speculation 132
Why Was the Shareholder-Value Criterion Elevated to Primacy as the Corporate Purpose? 134
Shareholder Value as the Control Instrument of the Firm 135
The Product as the Purpose of the Firm 137
The Dominance of the Shareholder-Value Orientation and the Holding Structure of the Firm 139
Perverse Incentives from Shareholder Primacy: Speculation Instead of Production 140
The Inversion of the Control Instrument of Shareholder Value to the Purpose of the Firm, and the Role of the Employee in the Firm 142
Does the Shareholder-Value Principle Lead to a Fusion of Shareholder and Manager Interests? 143

10 Financial Overstretch: The Epochal Disturbance of the Invisible Hand of the Market by the Financial Industry 147
The Disturbance of the Compatibility of the Acting Person's Aim with the Firm's Aim 147
Hyper-Incentivization and the Hubris of the Financial Manager . . . 148
Easy Credit and the Hubris of the Consumer 155
Credit and *Credo*, Economic Success and "Manifest Destiny" 158
Separating the Financial Services from the Value Creation for the Customer: Self-Dealing of the Banks as Shady Dealings . . . 162
The Financial Market Crisis as a Crisis Caused by Excessive Trust: Credit Enhancement and Excesses of Trust 163
Conflicts of Interests and Conflicts of Disinterest: Having an Interest in Credit Enhancement and No Interest in the Monitoring of It 166
From Big Bang Deregulation to Big Bailout, or: How Deregulation Ended in the Largest State Bailout of Banks in History . 167

After the American Financial Overstretch – Have We Reached the End of the Washington Consensus? 172
The Failure of Economics and Management Science 176
"Wealth in the Hands of Others": The Outsourcing of Asset Management and the Growth of Financial Intermediation as Causes of the Financial Crisis 179
On the Way to Lesser Inequality in Wealth Distribution? Distributional Effects of the Financial Crisis Towards Greater Equality 182
The Financial Crisis – Systems Crisis or Action Crisis? 183
The Way Out of Financial Crises 189

References 197

Name Index 211