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"Micro- and Macro- Approaches to Internally-driven Ethical Reconstruction"

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1. Introduction

In response to the financial crisis, and beyond, a new awareness has emerged on the importance of ethics in finance. Specific and highly publicised cases of fraud and ethical misconduct have profoundly damaged the reputation of the financial sector. Moreover, the perception has gained traction that widespread opportunism and sloppy integrity standards encourage reckless risk taking and corrupt the overall business climate in the financial world. The outcome has been loss of confidence and poor public trust in finance, which in turn has undermined business opportunities, alienated the sympathy of policy makers and the public opinion. Ultimately this state of affair widened the gap between potential and actual financial activity in terms for instance of intermediation of savings, bank deposits, insurance penetration, and investment opportunities.

The industry response however has been robust energetic and with encouraging results. Ethical reconstruction is figuring prominently in business strategies and communication campaigns. Moreover, it appears "internally-driven", i.e. originating from and building upon the business plans of the financial players themselves. Robert Annibale's paper, of Citigroup "Internally-Driven Ethical Reconstruction: Is It Happening?" - which I would like to comment upon - provides a clear illustration of the level of commitment and the variety of tools and programs that the leading enterprises in the trade have devoted to rebuilding trust, strengthening reputation and showing responsiveness to clients' needs and communities' welfare. The paper is highly informative and draws on concrete examples of corporate engagement in ethical reconstruction, aimed at consolidating public confidence and the credibility of the financial industry.

The questions we may wish to ask in relation to these actions and efforts are the following: a) Do these efforts match requirements?; b) Are they enough, and/or necessary?; c) Do they achieve expected goals and outcomes?

In the "Dublin Memorandum", issued by the Centesimus Annus Pro Pontifice Foundation in 2014, it is rightly stated that "to build ethics into finance, the proper place to begin is the corporation …". Annibale's paper provides a convincing case in support of this statement, showing how the market itself stimulates innovation and social engagement driven by a highly competitive environment. "But –the Memorandum adds- these efforts should combine" with efforts at different levels, i.e. the private with the public, the micro- with the macro-, etc.

This "combination" however is not a trivial affair, does not come by itself. It is in the blending of efforts from individual enterprises, government policies, regulators, business and industrial leaders and civil society organizations that lies the secret of success. Furthermore, in moving from the perspective of the individual corporation to that of society as a whole, there may occur a "fallacy of composition" - as economists call it. In other terms, it may happen that what is optimal from the standpoint of the individual corporation may not be optimal from the perspective of the economy and society as a whole. A well-known example to illustrate this concept is in the combination of a micro-prudential with a macro-prudential approach. From the perspective of an individual enterprise, and an individual regulator, increasing the number and the pervasiveness of controls and regulations should lead to greater safety and stability. But if the burden of rules and checks is increased for the whole industry, particularly following a countercyclical pattern, the impact on risk taking and the balance sheet of the sector may become negative and have a devastating effect, leading therefore not to more, but rather less stability and safety. Does this concept apply also to ethical rebuilding?

I will proceed as follows:

- First I will establish a few conceptual foundations, reviewing the notion of ethical capital, and linking it with uncertainty and solidarity;
- Second I will make reference to the global risk scenario and the challenges the financial sector has to address to rebuild public trust;

- I will then review the lessons learned at the corporate level and the best practise, drawing basically on the Citygroup experience;
- I will deal then with the issue of bridging the profitability gap through ethical investment, as an illustration of a possible fallacy of composition;
- Finally I will draw conclusions, focusing on the need for a global strategy, the importance of an industry-level dimension, and on putting "finance for the poor" at the top of the agenda.

I have been inspired and guided throughout by the Catholic social and economic thinking, and in particular, by the encyclical "*Caritas in Veritate*", which shifts the focus from the "ethical limits" of finance to its "ethical foundations". In so doing, it gives a further and more profound meaning to the "internally-driven" ethical reconstruction:

*"Efforts are needed – and it is essential to say this – not only to create "ethical" sectors or segments of the economy or the world of finance, but to ensure that the whole economy – the whole of finance – is ethical, not merely by virtue of an external label, but by its respect for requirements intrinsic to its very nature (**Caritas in Veritate**, par.45)".*

2. Conceptual foundations: trust, uncertainty and solidarity.

In the economic literature, the notion of trust as capital is a fairly recent acquisition, and presents still several elusive features (Acs 2015, Bull et alii 2010, also Shandwick, Spickard). I cannot in this paper dwell much on such features, but wish only to highlight a few elements of the framework that are required by the arguments developed in the paper.

a) Trust is an economic factor of production (social capital);
b) Trust was undoubtedly hit by the crisis of 2007-2013, but it has been eroded well before the crisis, and will not recover therefore automatically after the crisis. In other terms, there are both "cycles" of trust, and long-term "trends" of trust;
c) Trust is not a raw material, but a renewable source of capital. In other terms, it is both an input, and an output. Therefore, it can – and should – be produced and accumulated through investment and dedicated resources.
d) Lack of trust is inherently linked to uncertainty (F.Knight). Enhancing public trust implies creating a social order through (formal and informal) rules, but

also values and ethics. Norms guide behaviour and make it predictable and meaningful. Ethical capital therefore is part of social capital, a fundamental part of it.

e) Trust is inherently linked to love. Solidarity and social cohesion create an environment that stimulates public trust (see Nussbaum 2013). Even when and where one is confronted with the mysteries of life and the universe, we need not fall prey of fear and anguish. Generosity and the reasons of the heart, supported by faith, should come to rescue leading to trust (emotional capital). On this fundamental link, Catholic thinking has provided in my view its more specific and unique contribution (in **Laudato si**, there is a whole section on "Civic and political love"). "Social love is the way to authentic development" (**Laudato si**, par. 228).

In sum, ethical reconstruction should be seen as a very complex comprehensive and resource-intensive endeavour. It belongs to the "core" investment strategies of an economy, or an enterprise, more than to its "external" relations and communications campaign. It must start then from an in-depth understanding of the sources of fear and insecurity that are at the root of public mistrust; and strive to fill the gaps as much as possible with information knowledge and wisdom. Finally, it requires the commitment and engagement that match the challenges to address, i.e. the deployment of a strong sense of responsibility, solidarity and moral leadership.

3. The Prevailing Uncertainty of the Global Risk Scenario

We live in a world of unprecedented uncertainty. Daunting challenges confront us: terrorism and conflicts, massive waves of refugees and migrants, population aging and climate change, growing inequalities and social fractures, etc. The paradox is that the same forces that create new promises of prosperity and social progress are also at the root of disequilibrium and insecurity. Unprecedented longevity, globalisation, technological change, growing mobility, undeniable progress in education and in fighting poverty illness and hunger, new peoples and players emerging in the global economy: all factors that should open the way to a better future, but that feed instead anxiety and fear. The fact is that we have not been able to manage and steer the push towards change in a way that enables it to bring about its full potential benefit, and at the same time minimizes its costs and negative implications. The ordinary citizens therefore have reasons to be concerned. Inadequate global governance, economic and financial instability, growing deprivation and social vulnerability, the slowdown in output and productivity growth, the frightening solitude and alienation of many new urban landscapes.

These are only a few examples of the many problems that we have been unable to understand and address effectively, and that have led to crisis after crisis. Actually, among the many competing interpretations of the Great Crisis, the one I consider the most encompassing and convincing is the following: before the crisis, we were overconfident of our ability to cope with the global risk scenario, but then in the depths of the crisis we discovered that there are many thinks we do not know, e.g. about systemic interdependence or market clearing or democratic governance, and our institutional mechanisms proved inadequate to cope with the challenges. As we recover from the crisis, we are getting a better understanding of how the economy, finance and policies interact, and we are adopting the necessary institutional reforms.

Rebuilding trust implies coming to terms with this big and global picture. It is the first building block of ethical reconstruction. And it is huge.

4. Financial Development: More Solution than Cause of the Problem

This line of reasoning helps explaining why the financial sector appears more exposed to the threat of mistrust than other sectors. It is not simply that the crisis started in finance, that there were more fraud and scandals there, or that financial firms were not sufficiently aware and did not invest in it. The real reason is that finance deals with risk and uncertainty, is more reliant on trust than other business sectors, and requires therefore higher levels of integrity, human capital and education.

It is not surprising therefore to see that in the post crisis recovery financial development has come to be considered as a major driver of growth. Financial development and innovation is needed to channel funds towards infrastructure and SMEs, relaunch investment, provide new forms of protection vis-à-vis old age or climate change, support technical change and start-ups.

Finance is called upon to bring uncertainty under control by identifying measuring and managing risks. This requires a leap forward in knowledge and leadership. It is not “irrational exuberance” or “depression” that drives the ups and downs of financial markets, but rather their real and legitimate concern over our ability to understand and manage the challenges ahead.

A proof *a contrario* is in the success of the "whatever it takes" approach that the ECB has been using in steering monetary policy against deflation and instability. Markets regain confidence when they see that leaders are on top of things, and do not shy away from taking responsibility. If we had similar statements coming for instance from the European Council or the G20, in relation to the Syrian conflict or the migration tsunami, among others, the impact on public confidence would be formidable.

5. Build Ethics from Below: Lessons from the Corporate Sector

Individual firms, i.e. banks, insurance companies, pension funds, stockbrokers, financial advisors, etc., have been at the forefront of the battle for regaining the confidence of savers and the public. Corporate social responsibility, responsible investment, sustainable insurance and social impact investment have become new competitive tools in an increasingly competitive market. Competition has stimulated the dissemination of best practise and pushed operators towards investing more and better in business ethics. Branding has come into play as a tool for strengthening the image of social responsibility and the corporate identity of the firm as a caring institution.

Regulators have plaid a fundamental role particularly in the field of corporate governance, compliance, auditing and risk management. However, more than top down prescriptions, what is driving change is the pervasive contagion of best practise and leading by examples.

Internal "codes of conduct", particularly when built with employee-management cooperation, have been effective in producing ownership of the philosophy of good behaviour and an entrenched culture of integrity. They have to be monitored and supported by training, incentives and recognition mechanisms. A focus on "substantive compliance" is needed, capable of going well beyond the formal rules and the avoidance of legislative sanctions. People should feel responsibility for striving for the highest standards of integrity and business ethics.

The question of compensation particularly that of the top management has attracted a lot of attention, sometimes driven by populist campaigns. The issue however cannot be dismissed with a purely defensive response. It is true that adopting the "market rates" of remuneration and avoiding intrusive legislation is necessary to attract the best human capital and encourage "meritocracy". But responsibility should be exercised and excesses avoided.

In order to build ethics from below, the power of good examples and sound leadership is fundamental. Here lies one of the great strengths of the Catholic world and of the teaching of the Church. There is a great tradition, a tradition that is ancient prestigious and spread out all over the world, a tradition nurtured by exemplary cases of excellent work, like e.g. the cooperative movement or the Catholic missions in the developing countries.

Not enough in my view has been done so far for collecting analysing and making available the wide and growing experience of good practise in the field of responsible investment and sustainable finance. It is a question of information, data, case studies, but also of indicators, analytical and benchmarking tools. We need to better understand how ethical capital works, what motivates to invest in ethical capital, what are the obstacles and the constraints, what the returns, the impact and the outcomes.

A fully-fledged **monitoring mechanism** producing on a continuing and regular basis evidence, studies and policy analysis would be highly beneficial. Experience has to be gathered accumulated exchanged and compared, and a better assessment of progress made, or lack thereof, should be made.

6. From Micro- to Macro- Ethical Reconstruction: the question of Profitability

If one considers an individual case of corporate ethical reconstruction, one may think it implies less focus on profitability. To reinforce ethical standards and behaviour at the firm level is not a free lunch. It involves considerable resources. In short, "ethics costs"! The question then is: "Does ethics pay"? or better "Should ethics always pay?". In Annibale's paper, we find a strong statement on this point: "At Citi we are absolutely convinced that ethics pays". Perhaps we should qualify: even though this may not happen necessarily in all cases, in the short term, nor always, it is true that **in the long term, and looking at the generality of the cases**, ethics pays. It is undeniable in fact that many of the channels through which an increase in confidence generates returns that more than offset the increase in costs, do not necessarily operate at the level of an individual company, and in the short term. There are externalities, both negative (because a fraud in one firm reverberates negatively on the whole industry) and positive (because a case of excellence benefits widely the reputation of the sector).

The relationship between ethics and profitability therefore should be analysed more in depth. If we look at the return on equity (ROE) of Euro area banks in the last two decades (Graph 1), we see clearly a sharp fall between 2007 and 2009 that corresponds with the period of the financial crisis and the loss of trust that it entailed. But even before the crisis, and afterwards, the pattern follows a declining trend suggesting that also other factors were at play. Splitting revenues and costs (see Graph 2), we observe that revenues have been on a declining trend throughout the period, and the drop in costs has accelerated after the inception of the crisis, probably in an attempt at sustaining profitability and recovering the erosion of margins.

At the industry level, the question of falling profitability has been, and is of great concern and has been greatly debated and analysed. The squeeze on margins has been attributed to the low interest rates environment, growing competition, and mounting cost pressures. Sluggish demand has also plaid a role and it is likely that consumer and investor confidence has negatively affected demand. However, we are still far from clearly understanding to what extent and how ethical investment, by restoring public confidence and improving customer relations, can have an impact on profitability and invert the declining trend.

I believe that the greatest obstacle to bridging the profitability gaps has be found in the huge financial output gap that prevents the sector from developing at its full potential. Even in the most advanced market economies, we are facing less than optimal levels of banking, low insurance penetration, and insufficient development of capital markets. The gap obviously is much greater in emerging and developing economies. Let us consider for instance the possibility for increasing pension savings and health insurance. Or the need to find new ways of financing infrastructure and SMEs. Or the obstacles that prevent access to equity for start-ups and young innovators. The emerging new forms of welfare, the growing reliance on public private partnerships to finance investment, the new financial instruments for funding small firms (e.g. minibonds) and social infrastructures, show the potential for enlarging financial markets and making them more profitable, and more able to contribute to the common good. Progress in these endeavours is often linked to advances in knowledge and/or education. On both of them, ethics has a bearing, since public trust is required for fighting uncertainty and promoting solidarity.

It is clear in any case that a fallacy of composition may be operating here. What in fact may take place at the level of an individual corporation - that might have to sacrifice in the name of ethics short term profits to re-establish its reputation in the market -, does not apply to the entire market. For the economy as a whole, indeed “ethics pays”, or at least it should pay! And if it does not, this means that our efforts are not enough, are not well calibrated and coordinated, and therefore are not effective.

7. Conclusion: Towards a Global Strategy, Micro- Macro- and Meso-

In commenting on the excellent paper by Robert Annibale, which reflects the leading experience at Citi Bank, I underlined how important are the initiatives developed at the grass-root level by individual players in the financial sector, and more broadly in the business sector and in society. The Dublin Memorandum of the FCCPP pointed out that “to build ethics into finance, the proper place to begin is the corporation …”. There is a growing body of evidence to substantiate this statement, and much more could be learned if evidence were systematically collected, analysed and disseminated through some monitoring mechanism, which we propose to put in place. Starting from the experience in the Catholic world that should be at the forefront of providing, not only bold thinking, but also, and more importantly practical and concrete examples of good practise and success stories.

However, the Dublin Memorandum rightly adds that “these efforts should combine” with efforts at different levels, the whole of the private sector and the public sector, the stakeholders and civil society. We believe that it is in this “combination” of different initiatives, from regulation to government policies, from business strategies to consumers groups, from opinion leaders to academics, etc., that lies the secret of success. We need in other terms an overall “global strategy”, comprehensive of all the relevant players, including many different tools and levels, widely shared and consistently supported, a collective and concerted effort within a partnership approach.

In linking the corporate level with the community level, the financial sector can play a critical role that is often neglected. In other terms, between the micro-level and the macro-, a meso-level can be quite important. The finance industry as a whole can and should be perceived as a key player for the common good. A lot can be achieved by the collective efforts of banks insurance companies and funds, without necessarily having recourse to public policies and taxpayers’ money. The subsidiarity principle should be applied here. Leading players in the industry, particularly big corporations, should not only lead in their corporation providing concrete examples of good practise, but they should also exercise leadership in the industry working with other players, especially the smaller ones, in disseminating good practises and encouraging engagement and advancement. In other terms, in the financial sector there should be not only competition, but also cooperation on cross cutting issues, like that of ethics.

A lot remains to be done to convince the public that financial development brings about benefit not only to the firms in the sector but also to the economy as a whole. Showing that a successful model of sustainable development should be finance-driven remains by-and-large still an unaccomplished task (see for an example *a contrario* the report “Where next Europe” by the City of London Corp.). The many ways through which financial development can contribute to the common good should be more clearly spelled out and communicated to the public.

8. Conclusion: Focus on Finance for the Poor

On the issue of financial inclusion significant steps forward have been made from the Maya Declaration (2011) to the G20 White Paper on “Global Standard Setting Bodies and Financial Inclusion” (GPFI White Paper 2015).

- First awareness of the importance of the issue has increased at the level of Governments, international organisations (OECD, World Bank, the Basel Committee, etc.) and stakeholders’ groups.
- Second, we have acquired a better understanding of the risks and benefits of regulation in relation to the goals of promoting the participation of the underprivileged and the underserved in the financial activities. Regulators and standard setting bodies have been at the forefront of this monitoring exercise.
- Third, the analysis of the risks of exclusion has led to several important developments and innovation in the normative framework. For instance, the principle of proportionality and the SME supporting factor have been introduced and supported, due to the concern that an excessive regulatory burden on the weak and small enterprises would have undesirable and unintended negative consequences. A similar preoccupation in relation to underbanked and underprivileged savers and/or investors has led to a focus on inclusive consumer protection. De-risking is another item that has attracted attention, whenever financial intermediaries in response to the tightening of prudential norms engage in large-scale termination or restriction of business lines and relationships, affecting poor communities and developing countries.

- The impact of ICT and the very promising prospects of Digital Financial Inclusion have been analysed, particularly the growing role that crowdfunding could play.
- At the practical level interesting and turbulent transformations are taking place at the crossroad of financial innovation and new approaches to financing of social impact investment. New tools, new actors, new organisations are challenging traditional ways of providing support from philanthropy to public services. For a survey, see Salamon 2014.

In spite of these undeniable and significant improvements, the topic remains by-and-large underexplored from the analytical point of view, commitment is lacking and financial inclusion appears to be the "Cinderella" of public policy in the financial sector. This conclusion is endorsed by the White Paper of the G20 on the topic: "*progress on mainstreaming financial inclusion in Standard-Setting Bodies standards and guidance is not enough … progress on implementation must also be assessed*" (GPFI White Paper, 2015).

It is undoubted that a leap forward is required in financial inclusion goals and programs. The issue should be put at the top of business strategies and of the policy agenda. Efforts should be made at all levels and from all quarters to give prominence to this objective, and show concrete results. The credibility of our intentions and plans in consolidating ethics in finance is at stake. Financial development should benefit not only banks and the other financial intermediaries, but above all the "real economy" in terms of economic growth and jobs, and especially the most vulnerable segments of the social and economic fabric.

The poor are to be put at the centre of the world of finance.

"… there is little in the way of clear awareness of problems which especially affect the excluded. Yet they are the majority of the planet's population, billions of people. … we have to realize that a true ecological approach *always* becomes a social approach … so as to hear *both the cry of the earth and the cry of the poor*."

Pope Francis, **Laudato si,** par. 49

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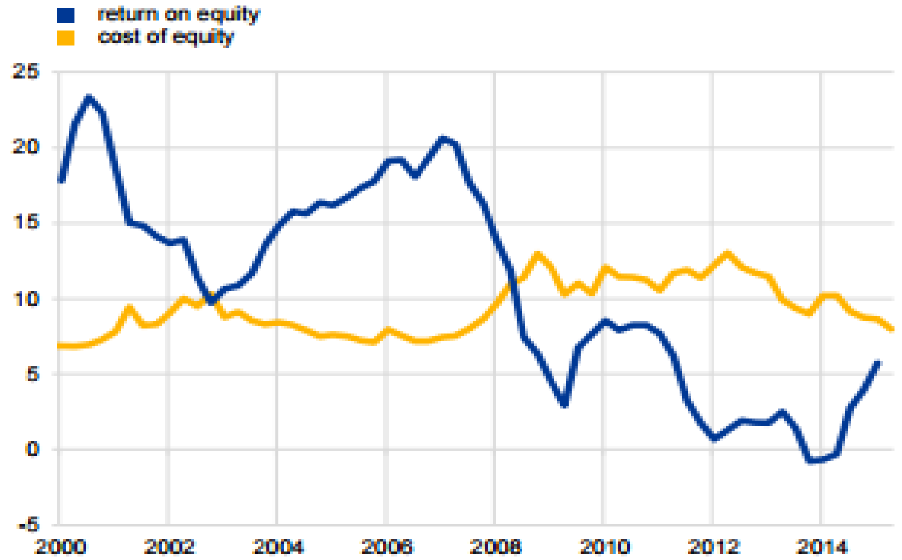
Rome, February 2016

Appendix

Graph 1

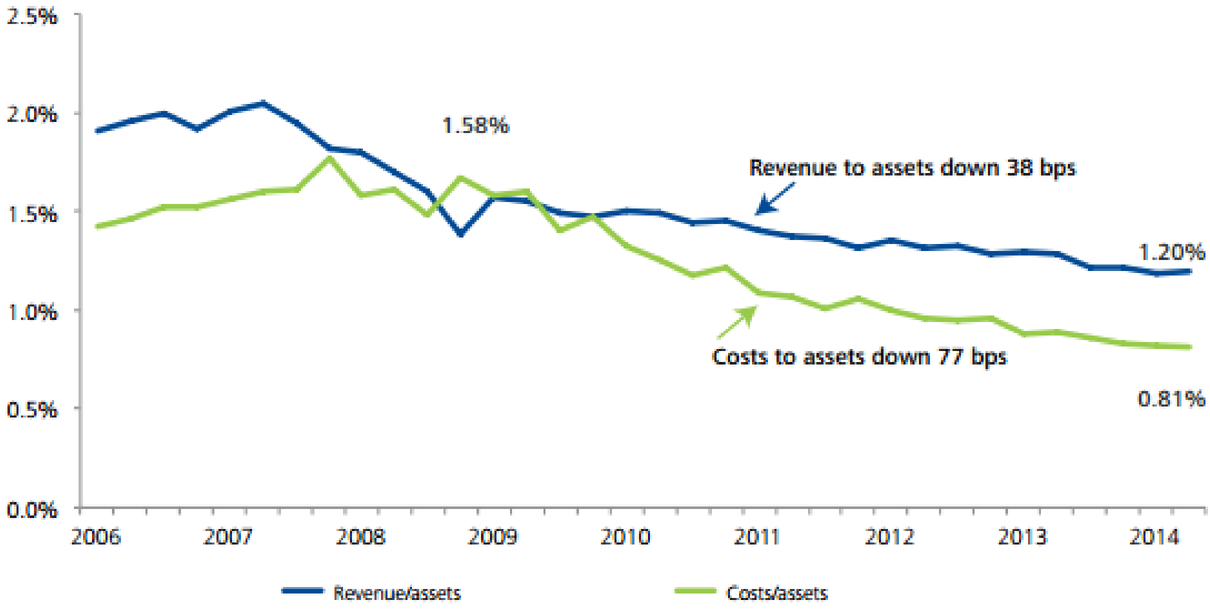
Cost of equity and return on equity for a large sample of listed euro area banks

(Q1 2000 – Q3 2015; percentage points)



Sources: Bloomberg, Thomson Reuters Datastream, Consensus Economics and ECB calculations.
Notes: Based on the weighted portfolio of 33 euro area banks in the EURO STOXX index. For further details, see Box 5 in *Financial Stability Review*, ECB, May 2015.

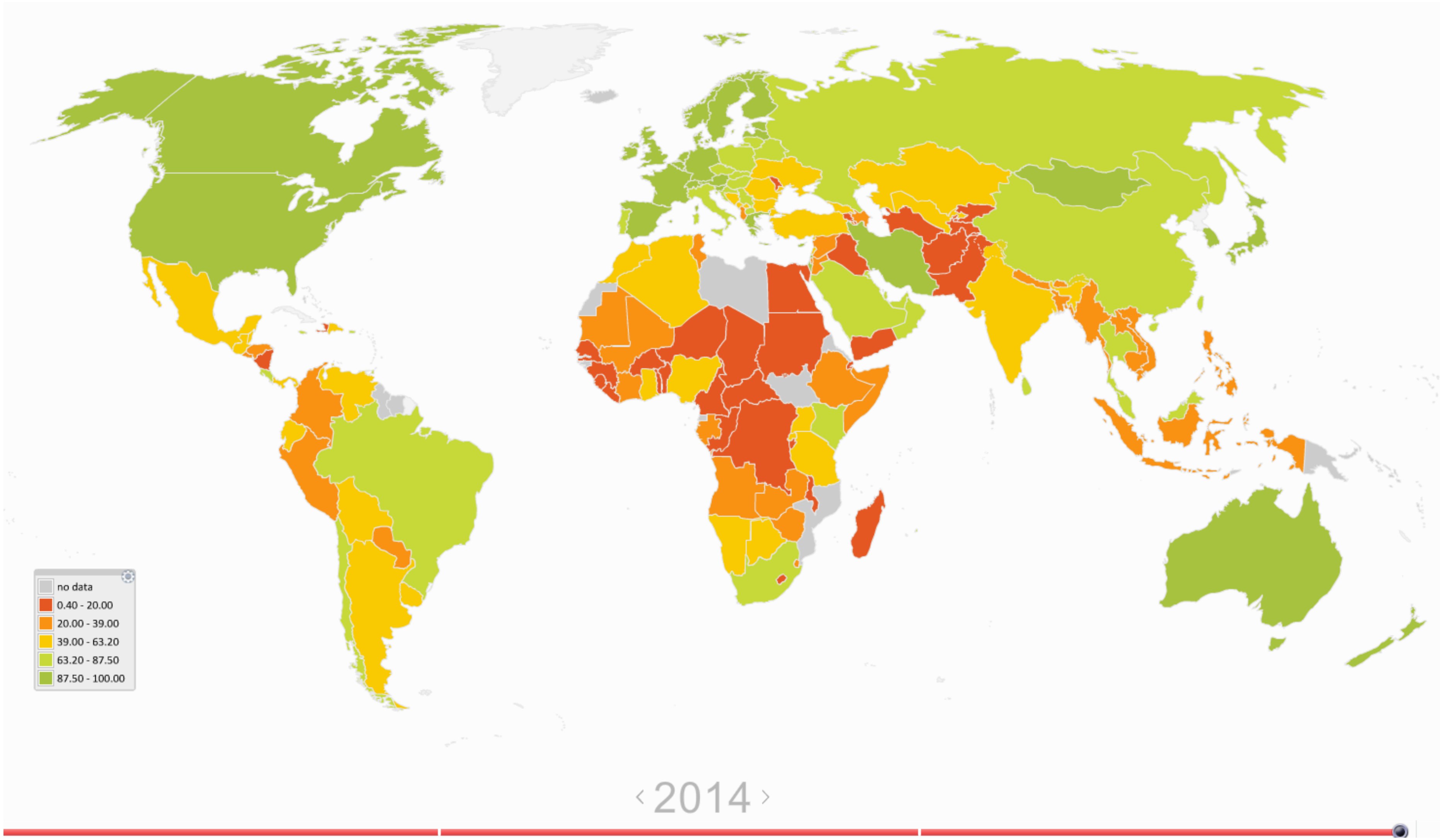
Graph 2



Revenue = Interest income, non-interest income, security gains
Cost = Interest expense, non-interest expenses, security losses, provisions

Source: Federal Deposit Insurance Corporation (FDIC) data for all insured institutions and Deloitte Center for Financial Services analysis

Financial Inclusion



Source: World Bank

Indicator: Account (% age 15+)