

*Ethics and the World of Finance**

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Thank you for inviting me to participate in this unique conference on 'Ethics and the World of Finance'. This topic would have been relevant at any time. But it is particularly so, given the current financial crisis which has called into question the ethical foundation of the financial world. It is also fitting that we are discussing ethics and the world of finance at Sri Sathya Sai University. The worlds of faith and economic development are profoundly intertwined, in both precept and practice. At heart, the strongest link is the aim to foster greater social justice.

Ethics and the World of Finance - the Canvas

2. I must admit I have not thought about ethics and the world of finance deeply or systematically before confronting the challenge of addressing this conference. And as I tried to collect my thoughts, several questions came to mind. How do we, as individuals, approach issues of ethics and values? Are our approaches different in our personal and professional lives? Are issues of ethics different in the financial sector? What are the ethical issues thrown up by the current crisis? Has economics, as an academic discipline, lost its value base? Is that the root cause for the malaise in the financial sector? How do we in the Reserve Bank interpret our mandate towards ethical standards and values in all that we do? These questions cover a fairly large canvas; and my scholarship and experience are clearly not adequate to cover that entire canvas. But I will address some of these questions in my limited capacity and time.

* Keynote address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the Conference on 'Ethics and the World of Finance' organised by Sri Sathya Sai University, Prasanthi Nilayam, Andhra Pradesh on August 28, 2009.

The Power of Context

3. We - all of us - confront ethical issues and dilemmas every day and we deal with them by our own standards. All of us know it is a constant struggle between sticking to the straight and narrow path of ethical virtue and succumbing to temptation. As individuals and families we manage this struggle in our own different ways, drawing the line for ourselves as we weigh the trade-offs.

4. A follow on question is, are our ethical standards of honesty, sensitivity, fair play and values absolute or do they change depending on the context? We all know that some people are more honest than others. But the question is, is an honest person honest all the time, or does her sense of honesty depend on the trade-offs in the specific context of a dilemma? Empirical psychology tests show that there is not a tight circle of honest people and another tight circle of dishonest people.

5. In his best-selling book, 'The Tipping Point', Malcolm Gladwell argues that something like honesty is not a fundamental trait, but is considerably influenced by the situation. There are specific situations so powerful that they can overwhelm our inherent predisposition. To buttress this argument, Gladwell cites a landmark set of behaviour experiments by two New York based researchers, Hugh Hartshorne and M.A. May. Hartshorne and May administered several types of tests to eleven thousand school children over the course of several months, all designed to measure honesty. The tests varied by subject, design, level, *etc.*, and the results are therefore quite robust. Some of the test

results are obvious. A few children never cheat, and a few always do. Less intelligent children cheat more than smart children. Older children cheat more than younger ones. Girls cheat about as much as boys. Some test results though are less obvious. For example, performance of children varied as between class-room exams and take home exams. Some children cheat in arithmetic but not in spelling tests. The surmise of this extensive behaviour experimentation was that between the binary extremes of a few who never cheat and a few who always do, there is a large grey mix. Some people cheat if there is an opportunity; some cheat if the stakes are high enough; some cheat if the chance of getting caught is small.

6. What do the above results mean for our value systems as individuals in our personal lives and in our professional lives? Do we have double standards? Are we more strict about breaking a self-imposed standard in our personal lives but do so with less pangs of conscience in our professional lives? I believe such compartmentalisation is not valid. Individuals carry their ethical standards and values everywhere, and how they resolve specific dilemmas and issues is determined not so much by the personal and professional domain of the dilemma but by the power of context that Gladwell cites.

Ethics in the Financial Sector

7. Let me now turn to the issue of ethics in the financial sector. As I said earlier, the question is, is the financial sector different from other fields by way of ethical dimensions? Is there a greater opportunity or larger temptation to deviate from the

straight and narrow path? Is the power of context more forceful here? Conversely, is it people of looser ethical standards and values who succeed in the field of finance? Again, this is a debate that defies clear cut resolution.

8. At one extreme are people who claim that the financial system, at its heart, is about trust. Nowhere is this more true than in banking. The word credit derives from the Latin word *credere*, meaning to believe. Billions, indeed trillions of financial transactions take place everyday, and all of these are based on trust. Without broad based trust and presumption of honest behaviour, it would not have been possible for the financial sector to grow to its present size and importance. As we have seen time and again, dishonest schemes where trust is breached implode and come crashing down. Two come to mind immediately, though there are, of course, many more. There is Nick Leeson, the British trader who single-handedly caused the collapse of one of England's most venerable banks in the mid-1990s; and there is the more recent case of Bernard Madoff, the former head of the New York Stock Exchange, whose Ponzi Scheme robbed millions of individuals of their life savings and looted the treasuries of charitable institutions involved in building social capital.

9. At the other extreme are people who say ethics and finance are poles apart. They contend that at a fundamental level, finance is all about making money, never mind how it is made. Status and recognition are accorded by how much profit is made regardless of how it is made. It is argued that even as the millions of foot soldiers may be innocent, people who rise to

positions of top management and leadership in the financial sector could not have done so without compromising on scruples. According to people given to this persuasion, there is a book called *The Complete Book of Wall Street Ethics* which is fat and bound and in which all pages are blank.

10. Even as this debate frowns on moderation, I believe the view that people in the financial sector are inherently less ethical than those elsewhere does not stand the test of empirical scrutiny. Yes, there may be larger temptations here given the money that can be made, and perhaps even bigger opportunities. But once again, it is the power of context that Malcolm Gladwell talks about that is relevant. It is not that professionals in the financial sector are inherently less ethical, but given the environment of the financial sector, there may be larger incidence of unethical behaviour. Consider, for example, Dennis Levine, the Drexel Burnham Lambert investment banker who was convicted of insider trading in one of Wall Street's biggest scandals. According to him, it was just so easy. In seven years he multiplied a paltry \$40,000 into \$12 million, and all it took was a 20-second phone call to an offshore bank a couple of times a month - may be 200 calls in total. He was confident that the elaborate veils of secrecy plus overseas bank privacy laws would protect him. Closer home there is the recent case of Satyam which allegedly window dressed the company accounts for over ten years, betraying the trust of all its stakeholders.

11. John Stuart Mill said that if we make men honest, good and decent, then they will make themselves honest, good and decent

engineers, doctors and teachers, and may I add, financial sector professionals. The financial sector is, after all, a reflection of the society in which it operates. So, the approach to bringing ethical values into finance has to begin not by special efforts to enforce or regulate ethical standards in finance, but by fostering a value system in society at large.

Ethical Issues Thrown Up by the Financial Crisis

12. This global financial crisis has been the deepest, broadest and most hurting financial crisis since 1929. All of a sudden, it seems like an entire super structure was built on sand instead of rock as it was believed. We are too close to the crisis to really grasp how this crisis might, as they say, turn out to be game changing. What the crisis has done is to cause a massive break down of trust: trust in the financial system, trust in bankers, trust in business, trust in business leaders, trust in investment advisers, trust in credit rating agencies, in politicians, in the media and in the process of globalisation.

13. When you break down the complex gamut of the causes of the crisis, several skeletons tumble out of the cupboard. Almost all of these relate to how the financial system operated. In a phrase that has now become daily staple, sub-prime borrowers were given loans at teaser rates. And these borrowers were led to believe that they would never lose as the price of the house they were buying will only keep going up. The loans were sliced and diced, built into complex products and rated by rating agencies. Dazzled by these ratings, gullible

investors lapped up the mortgage based assets (MBA) not realising the risk they were taking. Meanwhile investment banks took the MBAs off their balance sheets so that they could leverage once more and repeat the cycle of sub-prime lending.

14. At one level, it is possible to argue that nobody in the entire chain did anything legally wrong. But that is too simplistic an argument. We do not govern our behaviour simply by what is allowed by law or regulation. Our code of conduct should be held to a stricter test. Was the behaviour of actors across the chain of the financial sector fair, ethical and moral or was it swayed by the opportunity of making quick profit afforded by information asymmetries? Were sub-prime borrowers adequately warned that there is a good chance that asset prices would fall? Did investment advisers tell their clients of the risk they were taking in buying MBAs and CDOs? Did credit rating agencies not compromise their standards and cut corners? In sum, were professionals in the financial sector legally right, but only legally right and morally wrong?

15. The crisis has also exposed an issue of moral hazard in the banking system - something that has come to be called privatisation of profit and socialisation of costs. Banks enjoy an implicit guarantee of government bail out. This is true regardless of whether a large segment of the banking sector is owned by the government as in our country, or whether the banks are privately owned as is the case in most countries. Governments, regardless of their political affiliations, can hardly afford to have large institutions fail. This 'too big to fail' syndrome enables financial institutions to

take risks that, say a soap manufacturer, cannot take. If as a result banks make huge profits, they can reward themselves with generous pay packets and bonuses. And if loans sour and the balance sheets crash, no worry since the bank will be bailed out at tax payers expense.

16. The difference between the financial sector and other businesses is therefore quite clear. If say, a soap manufacturing company is an astounding success, who benefits? The shareholders and the management. And if it fails, who loses? Both of the above. But in the case of a bank, the story is different. If the bank is a success, who benefits? The shareholders and the management. And if it fails, who loses? Not the shareholders and the management, but the public at whose expense the bank is bailed out. The ripple effect is less pronounced but similar in the case of all institutions in the financial sector even if they are not banks.

17. That crucial difference, I believe, underscores the special ethical dimension of the financial sector in contrast to other businesses. Banks and financial institutions have a greater responsibility of being conscious of the obligation they have of not jeopardising the larger public interest. What Mahatma Gandhi said, that businesses hold public money in trust, is more true of the financial sector than others.

Ethical Basis of Economics

18. The crisis has also triggered an interesting, if also a soul searching debate on whether the malaise that we have seen in the financial sector might in fact be a result of the flaws in the direction that

economics, as an academic discipline, has taken over the years.

19. Some of you may have read in the papers that Queen Elizabeth visited the London School of Economics a few weeks ago and reportedly asked the economists there, "why did no one see the crisis coming?". The Queen's question is understandable given the growing claims of economics to hard predictive power like other exact sciences. Over the last several decades, the direction of economics has been to position itself more like a natural science rather than the social science that it actually is. As Lord Skidelsky argued in a recent article in the Financial Times, economics tried to be more like physics with precise predictive abilities based on mathematical models rather than like sociology or psychology where the outcomes are determined by human behaviour and therefore beyond the pale of precise modelling and exact predictions. Undoubtedly, the mathematical models helped economic analysis and aided in determining optimal solutions. The trouble though was that the mathematical abstractions got carried too far, and in the process economics lost its link with real life situations that it was expected to study and analyse. In other words, mathematical models became an end in themselves and assumed a life of their own.

20. What does value orientation to an academic discipline mean? Let me explain through two illustrations, one that may be considered to be in the realm of theory, and a more complex one all of us could run into in our professional lives. Suppose you are given a problem in a test, say an accounting examination. You are asked not only to solve

the problem, but also to comment on questions such as, 'was that way of accounting legal?', 'was it ethical?', 'was it chosen because it was convenient for the firm?'. What will your take away be from such an exam? Not just the technique of accounting, but the values that must underline accounting.

21. Problems in real life tend to be more complex, and reflect real behaviour. My second illustration is a variation of what is called the ultimatum game. Say, a team of two people, A and B, accomplishes a task by putting in equal effort, 50-50. The manager gives Rs.1000 to A and tells him to share it between them according to their respective contributions to the task. The rules of the game are that A can divide the money in any proportion he wants. And B has the option to accept or reject the offer. If B accepts the proportion in which money has been divided, both get to keep the money. If B rejects the offer, both lose and the Rs.1000 goes back to the manager. The rules put pressure on A to divide the money at least roughly in proportion to their respective contributions. Anything markedly out of line will annoy B, and she will likely reject the offer even if she is losing what she otherwise could have gotten. In other words, in the face of overt dishonesty, it becomes more important for B to make A lose rather than cut losses for herself. The ultimatum game illustrates how you cannot move ahead in life or in business without a sense of values.

Tools and concepts of ethical reasoning belong with the other valuable instruments of financial practice.

22. People often forget that the godfather of modern capitalism, and often called the first economist - Adam Smith - was not an

economist, but rather a professor of moral philosophy. Smith had a profound understanding of the ethical foundations of markets and was deeply suspicious of the 'merchant class' and their tendency to arrange affairs to suit their private interests at public expense. In his book, "A Theory of Moral Sentiments", Smith argues that a stable society is based on sympathy, a moral duty to have regard for one's fellow human beings. In short, Smith emphasised the ethical content of economics, something that got eroded over the centuries as economics tried to move from being a value based social science to a value free exact science.

Ethical Dimensions of Reserve Bank of India's Mandate

23. I note that following my speech and that of my senior colleague and widely respected former Governor, Dr. Reddy, this conference has scheduled two panel discussions. The first is on the 'Role of the Regulator - Governance and Regulation' and the second on the 'Role of Individual Financial Institutions and Corporate Responsibility'. I also note that the panellists are some of the most distinguished leaders of the Indian financial sector. Both these topics have a connection with Reserve Bank's role and responsibilities. So, let me briefly, touch on the ethical dimensions of Reserve Bank's mandate.

24. The Reserve Bank has a broad mandate. As central banks go, I believe we are a 'full service' central bank. We are the monetary authority, we issue currency, we are the regulator of banks and non-bank finance companies and much of the financial markets. We also regulate the payment and

settlement system. We are the debt manager for the central and state governments and the gatekeeper for the external sector. What guides us in fulfilling this broad mandate is a sense of institutional values and professional integrity.

25. Let me give a few examples. One of the core aims of monetary policy is to maintain price stability. If we fail in that regard, there would be inflation. And inflation, as we know, is a perniciously regressive tax that hurts the poor the most. So, by maintaining price stability, we are safeguarding the well being of the poor in society.

26. We take our regulation responsibility seriously. An important guideline for regulation is to protect the interests of depositors. We therefore ensure that banks are well capitalised, prudently managed and that they have adequate and appropriate internal controls.

27. Our regulatory responsibility also casts an obligation on us of protecting the interests of the borrowers. We need to ensure that borrowers get credit at remunerative rates of interest and that they are not disadvantaged by information asymmetries. We advise banks not to charge excessive/ usurious rates of interest on non-priority sector personal loans and credit card dues. We have asked that banks should communicate publically information on the maximum interest chargeable to any type of loan or advance. We have mandated that service charges should be reasonable and have some relation to the cost of rendering the services. We have a system of banking ombudsman to address the grievances of customers. I cannot claim that we are the best practice in dispute resolution, but I can

claim with pride that we try our best to be the best practice.

28. In recent years, we have been focussing on financial inclusion and financial literacy. The aim of the financial inclusion campaign is to provide access to financial services to people in remote and rural areas and poorer segments of the society. Our stress is on expanding the reach of financial services to ensure that every household has a bank account. But the aspiration extends, beyond merely chasing a target, to the quality of financial inclusion. Not only should the poor have an account, but they should also be getting the benefit of the account by way of credit and other financial transactions. The aim of the financial literacy programme is precisely that - to educate people on the type of services that they can get from the financial sector, on the rights that they have and on the grievance redressal mechanism.

29. Finally, we are deeply sensitive to the Reserve Bank's role as the issuer of currency. A billion plus people place their implicit faith in the currency signed by the Governor promising to pay the bearer on demand the face value of the note. It is this faith that makes people keep the currency as a store of value. It is this faith that enabled us to make the transition from the inefficiencies of the barter system to an efficient cash economy. It is this faith that underlies hundreds and thousands of cash transactions that take place every day and keeps a sixty trillion rupee economy going. The preamble to the Reserve Bank of India Act enjoins on the Reserve Bank, among other things, of 'securing monetary stability'. Maintaining the integrity of the currency note signed by the Governor is a responsibility that the

Reserve Bank treats as sacrosanct - not just as a legal mandate but as an ethical responsibility.

Conclusion

30. Let me now conclude. To summarise, I have argued that all of us as individuals, families, social communities and faith communities confront ethical dilemmas everyday, and we resolve them in our own ways. Notwithstanding where we draw the line, we take the value of ethical behaviour to be axiomatic. There is no evidence to show that people in the financial sector are inherently less ethical than people in other professions. However, given the larger temptation and more opportunities, the power of context to be short, there could be greater incidence of unethical behaviour in the financial sector. Drawing lessons from the crisis, I have argued that because of the very nature of the financial sector,

leaders and top management in the financial sector have an extra obligation to be sensitive to larger societal obligations. I have raised the issue of economics, as an academic discipline, losing its value base, and conjectured if that could be at the root of the malaise in the financial sector.

31. I have also outlined how a sense of responsibility to larger societal good underpins the mandate of the Reserve Bank.

32. Let me also mention that the year 2009/10 marks the platinum jubilee of the Reserve Bank of India. We have planned a number of events to mark and celebrate the occasion. The theme of all our celebration is 'how can Reserve Bank of India make a difference to the lives of the ordinary people in India?'. This theme draws again from the professional value system of the Reserve Bank.

33. I wish this conference on Ethics in the World of Finance all success.