What is the price of morality in financial markets?
By Andy Brookes

Imagine you are an investment banker. Picture yourself three years ago at a dinner party answering the question “What do you do?” Imagine the same conversation this weekend. If you are anything like my friends, your intonation and enthusiasm when announcing your career will be rather different three years on. A hint of shame hangs in the air. Why? Surely, it’s ‘just a job’?

Before plunging into discussion of morality and markets, let’s step back and see if we can pen a consensus view of the crisis.

Nature of the financial crisis

I think we can agree with much of the recent thoughtful commentary on how we got here, the causes of the problems, and, though more difficult, the ‘what now?’

Taking those three in turn...

How did we get here, a recap? I explain it to my school age children as follows: China makes ‘things’; these things were sold to the US; then, instead of spending that money, China lent it back (as do the oil exporters, and Germany bye the bye) to the American (and British, Spanish, and Irish) citizens – let’s call them ‘consumers’. These consumers spent those recycled dollars, buying the things that China made. These same consumers bought houses, facilitated by an innovative and (we now know) under-regulated financial sector. Off went the asset price bubble, endorsed – underwritten, even - by the recently venerated, now criticised, Chairman Greenspan.

Cometh the bubble, cometh the pop: with its rapid unwinding of the debt/asset price spiral and the associated convulsions in the financial sector.

What were some of the underlying problems that got us into the mess? Five for starters:

• The incentives faced (perhaps even created?) by the banks and other financial sector institutions. I’ll return to this question of incentives in a moment.
• ‘Incorrect permanent income expectations’ – to use a phase from economic man - on the part of consumers; borrowing too much, to you and me.
• Monetary policy setting, which – for no doubt sophisticated reasons - let the asset bubble run.
• Fourth, regulation that, as Lord Turner Chair of FSA put so well, ignored both the potential for markets to be wrong and the systemic consequences of regulation focussed on individual institutions. (An aside: knowing a number of senior regulators, I would caution you to beware cheap scorn aimed at them– would you have done it differently? Would you and your banks – I address you as customers and perhaps shareholders - have accepted then the kind of ‘intrusive’, ‘be afraid’ regulation that we now believe is necessary?)
• Fifth, fiscal imprudence; the result, at least in part, of over-estimating the sustainable rate of growth. A sobering reminder for those of us who welcomed then Chancellor Brown’s “We have made our choice” budget to increase spending back on social priorities in 2001.

What now?

Well, of course, who knows? On the strength of ‘recovery’ it’s the view of the equity market (bouncing back) against the widely held view that deleveraging – the reduction in debt levels - will take years to work through.

Meanwhile, officialdom – government, central bankers, regulators – seek to maintain the right level of short-term stimulus alongside longer-term fiscal retrenchment; plus discussion on how best to reform the financial system.

So we have an overview, one consistent with that from many leader columnists.

The underlying unease

Against this background, how many of our fellow citizens feel uneasy about the bonuses paid to bankers? My straw poll suggested a good 80%+. Second round data – the willingness of politicians to intervene on the issue – points in the same direction.

What is at the heart of this unease? I suspect it is more than jealously – but let’s not ignore that – and more than the blindingly obvious observation that the fruit of the previously all-conquering financial sector has been distinctly bitter of late, particularly for the tax payer. I think that the financial crisis has brought to the fore a repressed unease about both the financial sector, and markets more generally.

Average dinner party Josephine’s unease about the financial sector melds several distinct criticisms.

• Finance is too large as a share of the economy, “sucks up too many of the best grads....” etc
• Much of our current financial sector is a sort of make believe, all that “making money out of money”. Put a little more rigorously by Lord Turner much innovation in financial services is “not socially useful”.
• The average remuneration of a person working in finance is too high, relative to those working outside finance
• The ratio of high to low pay within finance is too great. Many millions for Bob Diamond at Barclays; somewhat lower in the back office.
• The risk/reward trade-off for individuals working in financial services was (perhaps, still is?) skewed, such that bankers and the like are incentivised to take more risk than they should.
The second set of concerns relate to markets, and our faith in them. (‘Faith’ is deliberate, as our talk about markets frequently takes the form of a quasi religious commitment.)

Let me caricature: markets are ‘natural’; they just are in some autonomous (law unto themselves) sense; markets are independent of values. Put these sentiments together, and you can be left with a sense market outcomes are in some sense ‘right’ and unchallengeable. You can’t argue with the market.

Financial markets bring these two areas of concern together, and, particularly when the fruit is bitter, leave many feeling uneasy, if not downright angry.

**Insights from economics, with a hint of morality**

We can explain why bankers are paid bonuses – because it is much better than paying them equivalent salaries. Bonuses are a means of transferring risk and volatility from the corporate to the employee. In most occupations, risk is transferred from the individual to the firm. I have productive days, and less productive days; my current employer smoothes these, paying me the same each day. In finance, the volatility of productivity (= profitability) can easily kill the firm. So sharing this risk with employees is helpful.

It helps to smooth not just profits, but employment, which makes sense for the firm. If a successful applicant to Goldman Sachs has 20 interviews, the firm does not want to throw away that cost away lightly. Bonuses, as oppose to salaries, help do that.

Note the difference here between investment and retail banking - casino versus utility in shorthand, with investment banking as the casino, and retail as the safe utility. The bonuses in retail banking are generally not high, commensurate with the risks taken by individual employees. In investment banking, the opposite is true. Hence bonuses are a higher proportion of remuneration in investment banking than in retail.

Bonuses are thus an attempt to align incentives. But how successful are they? The phrase “privatisation of gains; socialisation of losses” highlights a shortcoming. If a financial institution is too big to fail, the risk takers are tempted to exploit that. If the bets come off, they share in big profits; whatever the losses, and resulting consequences for the taxpayer, they keep their houses and bonuses from the previous years. “Head’s I win, tails you lose”.

In this context economists talk about “agent/principal” problems, and “asymmetric information”. This is an everyday phenomenon; as plumbing demonstrates. I don’t know the first thing about it; so when my chosen agent sucks his teeth and says “I wouldn’t have fitted the boiler this way; it won’t be cheap to fix.” I am rather stuck. I want his incentives to align with mine; but they don’t. Hence the phrase “do you know a good plumber?” in economist speak is “do you know a plumber who has the requisite informational advantage, but does not exploit it, preferably because there is a credible punishment mechanism?” Probably easier to say “Do you know a good plumber?”
When faced with problems like these, economists and regulators first instinct is to try to fix the incentives – align those of the agent (the banker) and the willing principal (the shareholder) or the unwilling principal (the tax payer and his agent, the regulator).

Let’s put a marker down from a moral perspective: these issues are not simply about setting incentives correctly. We are moral creatures; hence our visceral cry of “this is not fair”. The banking community is being forced to recognise this dimension: CEO’s giving their bonuses to charity, or waving them all. Economists are prone to thinking solely about agents and their incentives, underplaying the moral aspect of economic life.

What about the nature of banking? I always find Paddington Bear useful here. You may remember that Paddington, having heard of interest payments, was quick to deposit his cash in ‘Floyds Bank’ (sic). Being a touch OCD – that obsession with marmalade attests – he noted down the serial number. Withdrawing his money sometime later, he challenged the bank for trying to fob him off with a different note.

A neat (over the) counter illustration of the true promise lying behind banking - “You will get your money back”.

Reneging on a promise is morally deflective; it is wrong, whether that is letting down a mate or failing to honour the fundamental promise that underpins banking.

Alongside the promise, the other plank of banking is the maturity transformation. A short-term liability for the bank – your deposit; is turned into a longer-term asset - your mortgage, your firm’s loan.

The promise – “you will get your money back when you turn up” – is required to stop us all turning up and upsetting the maturity transformation.

Three years ago one would illustrate this by reference to the Dawes, Tomes, Mousely, Grubbs, Fidelity Fiduciary Bank. Now, we can just think ‘Northern Rock queuing’. The maturity transformation – Northern Rock’s strategy of borrowing short to lend long – and the associated promise, unravelled before our eyes.

**Thinking morally: a framework and some footins’**

So the incentives and promises of our financial markets have a moral dimension, but how might we take this thinking further? I hope I am not giving you the sense that God’s will for finance is going to be set out unambiguously on page 307 of your pew bibles. It isn’t. We are going to have to work at this and with suitable humility – we see through a complex option, darkly; as St Paul might have said had he hung out at Canary Wharf.

But if we are to think about this within a Christian framework then we need to establish what we mean by that. Let me try the following on you: the world view of Christianity in six Cs and an R.
The first C: creation. God made the world and everything in it. And his style of making is not that of the (sighted) watch-maker – wind it up and step back to see the show. He continues to sustain the world He has made.

‘Creation’ includes the stuff in which man has a hand; remember that line about our being made in his image, and being given the responsibility for continuing the good work? The underlying point for these purposes is that the creation is not static. Art, sport, micro-chips, financial algorithms, markets even are, in this sense, all part of the first C: creation.

Second C: corruption, or the fall. Think of fruit in the Garden of Eden. We, humanity, blew it – and continue to blow it – making choices with reference primarily to ourselves, not the God who made us.

Given creation and the fall, then it is likely that we will find much to affirm in our world, including within investment banking, and much to criticise. The creation is still good; the fall ubiquitous.

Does God bailout at this point in the story? No, He continues to sustain the creation, damaged though it is, and sets about the rescue plan. It begins with Israel (that’s Chosen People if you are locked into the C business), is fulfilled in Christ (4th C) who ‘recreates’, starting with the Church (5th C). And the 6th C is Consummation; the return of Christ and the full putting right, with no discussion, of the created order.

If that is the 6 Cs, what’s the R? Redemption. God’s rescue plan, at work from the fall onwards. And our job as Christians is to be both the objects of redemption and to be agents of it, working in step with God’s redeeming activity; co-workers, if you like. What is the job description for this co-working? It is to live and influence our world; to order it as He would wish it to be. For those of you of a more theological mindset: “Kingdom of God” – which I pragmatically translate as “doing stuff His way”.

Frameworks are all very well, but can we have something more concrete, something to help us ground this framework? My father was a builder in Worksop for over 50 years, and to his credit survived the recessions of the 70’s, 80’s and 90’s. He knows a thing or two about foundations, the ‘footins’. If we are worried about our moral footins’ – and my contention is that we are, and rightly so – where better to look than the historic cultural and moral foundation of our culture: Christianity. What footins’ might we find to help us rebuild after our economic and financial earthquakes?

A first footin is to let God out of the religious box to which we have consigned Him. An Old Testament prophet will help us here. Google Isaiah 28, verses 2-28. You will find some of God’s very practical wisdom for farming. Talking about the farmer (not the vicar) Isaiah says: “His God instructs him and teaches him the right way.” And again: “All this [that is, agricultural advice] also comes from the Lord Almighty, wonderful in counsel and magnificent in wisdom.”
I wonder if your reaction is like mine? As a suit-wearing member of the professional, financial classes I instinctively distance myself from the imminence of the advice and its implications. Surely God can’t really be interested in the minutiae of the tasks I do every day? Insurance market processing; retail; manufacturing – topically, banking? Doesn’t He have better things to do; more ‘spiritual’ things? Actually, no. The God who knows every fatal aviary descent, who indulges in follicle numerology, has both insight and prescription for all areas of human life.

Our reaction tells us how deep something called the ‘sacred/secular divide’ runs within our culture. The false idea that God is interested in prayer, church, cathedrals, saving souls, may be family; but politics, sport, art, business are ‘worldly’ pursuits, to which God is, at best, indifferent. Nonsense. He is at least as interested in our use of the swaps curve as our pointing of the church porch.

So our first footing is that all economic life is part of the creation, and is lived before God. Nothing is out of scope.

Second, God has views – that’s rather weak, better to say normative insight; prescription for the way it should be; dare we say, judgement too? - for all areas of human life, including banking, finance and economic management.

You might note that God’s wisdom on the very practical matters of herbs and arable farming was not given from above at Sinai. It was discovered – like Michael Angelo’s sculptures within the block of marble – in the chipping away, the trial and error of human activity conducted before the face of our gracious God. In science, Kepler characterised it as thinking God’s thoughts after him - so too for town planning; catering; IT; economics and finance.

On a similar tack, how do we understand Jesus driving the money changers from the Temple in Jerusalem? Jesus is not proclaiming that we shouldn’t run raffles in places of worship; that God and ‘spirituality’ do not mix with money. He is instead being deeply political, striking at the heart of a self-serving, hubristic, inward-looking institution. The Temple had strayed from its calling to be a blessing to all nations. It had come to exist for its own glory, and that of its supposed stewards. Sound at all like the financial sector over the past two or three decades?

Like the Temple, the purpose of finance is not the success of the financial sector.

Similarly, the purpose of any company, its reason for being, is not – at the risk of heresy - the maximising of shareholder value. If loving our neighbour is the maxim, then the purpose of all economic life, including the plc, is to love our neighbour.

Smartly substituting ‘customer’ (or even ‘stakeholder’) in place of neighbour, we can say that the purpose of a firm, including financial ones, is to serve its customers and thereby earn a

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1 See Mark’s ‘gospel’ (short biography of Jesus) chapter 11:15-18
return for those whose capital is put to use, and risk, in that service. Which gives us our third footin – the purpose of economic life is to serve our neighbour.

Our fourth footin requires the digging out of one of the false foundations of the current age. Economics – personal and corporate - is to be understood as part of God’s creation. One of our sins has been to treat economic life as the purpose and true meaning of all life. It isn’t. This cuts across the practical hegemony of economic activity, the lie that consumption and work is all; and the intellectual imperialism, with its tendency to reductionism, of economics as a discipline.

So we have our framework: 6 C’s and an R. Plus four theological foundations: all economic life is lived before God; He has wisdom, norms and practical advice for our economic activity; the purpose of economic life is to bless and serve others; and that economic life is not the be all and end all.²

**Building on the footins**

Our foundations can help us critique the financial sector’s recent hubris. In turn let’s consider financial markets from three perspectives: first the ‘top down’ view, a necessity for regulators and policy makers; second, that of the firm; and third, the individual.

### 1 A market perspective: Policy and financial regulation

A Christian understanding of creation and the fall suggests that creation embraces all human activity including exchange (Cain and Able trading meat and veg, before it all ended in tears?); and that that all this activity is shot through with the fall. We then have a question: is any given activity, finance in this case, ‘redeemable’? Can it be put right? Is it within the scope of God’s (and hence our) redemptive activity?

Let’s consider a rather different activity, pornography. I don’t believe the economic activity of pornography can be redeemed. It is inherently exploitative. (Is that why the OFT don’t assess that particular sector for contestability, value for money, or consumer protection?).

What about finance? Is finance irredeemable? Occasionally I have been asked: “How can you, as a Christian, work in the wholesale financial sector? It’s characterised by greed, lack of service to the customer, and gross inequality.” The attitude behind the question hints that finance is beyond the pale; irredeemable. If you believe that finance is, per se, irredeemably evil then

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² A rather important footnote if one wants to get a handle on Christianity. First and foremost, God didn’t give us a framework, however neat and helpful. He came as a person, Jesus Christ. Truth embodied, incarnate, made flesh. And He continues to come to us by His Spirit. A good reminder to hold lightly to these neat formulations, however useful they may be.
the moral thing to do as an individual is to get out, and as a policy maker to shut it down; or at the very least to regulate it within an inch of its life.

While the financial services industry has indeed much greed, poor service and inequality; I do not believe that is a reason for condemning finance per se. Our reference point – scripture – does not hold this view. It contains lots of warnings about finance and money, and many to the rich to beware using their power to oppress the poor, but there is no sense that finance as an activity is irredeemably evil. The implication then is that it can be done in a God honouring, man serving way.

But evil will always have to be contained. Markets can be a means for limiting evil - you can choose not to go back to the plumber who ripped you off - but are themselves subject to corruption, hence the need for transparency and regulation.

Assessment of markets does not stop with the criterion of economic efficiency. The moral aspect of “fairness” is part of our being a body of people together; a society. This societal perspective legitimately asks hard moral questions: Is it fair, is it healthy, is it virtuous for our society to have a financial sector of this nature and scale?

Central intervention and framework setting – in pursuit of more efficient or more moral outcomes – is necessary and welcome. But our foundations point to limits on that intervention, and, perhaps, a bias towards a ‘market’ framework. First, our understanding man’s continuing role in creation points away from tight, centralist solutions. Regulation is needed to ‘contain’ evil; yet our ability to co-create with God needs some room to flower.

Second, the fall extends to regulation and intervention – the opportunism of some of the recent banker bashing by those whose doors were open to influential bankers only a few short years ago, and the propensity of public agencies to squabble, ably illustrates this.

Be clear that ‘the market’ towards which I am therefore biased is not the autonomous, ‘answer to nobody’, bound to be right, market of my earlier caricature. Any market is our creation, expressing our values, commitments and behaviours. It is not beyond judgement or modification.

But a moral assessment of the financial sector is not limited to a ‘top down’ discussion of policy; it also has implications for firms and individuals.

2 The firm

We established earlier that the purpose of the firm is to intentionally serve its customers (= love its neighbour). This confronts head-on the temptation to think of firms as ‘billiard ball’ economic agents. The billiard ball view is that firms simply optimise within the regulatory framework they are given; competition forces them too. This is simply not correct. Firms are moral enterprises, formed of moral beings. Just as individuals have the potential for moral reflection and decision, so do firms; and they have a responsibility to do so. The defence “we were just following ... incentives” is hollow.
It is not just the Body Shop school of corporates whose actions demonstrate explicit ownership of moral responsibility. Take corporate social responsibility - "How should we live out our wider responsibilities to the societies in which we have our being?" Ditto audits of environmental impact.

A hard, competitive environment tests a firm’s moral fibre and reduces its scope for discretion. But it does not remove it. At the micro level, take my father in Worksop. He owns a property from which those enjoying (?) big nights out are served kebabs at 3:00am. When the economy turns down and the rent gets behind, my Dad has choices. They are simultaneously business decisions and moral choices. Ditto the bonus payments at our banks.

Any firm needs to be explicit that its decisions – bonuses and the rest - have a moral, as well as morale, dimension.

Some firms’ performance management – annual appraisals to most of us – include assessment against values and behaviour. Remember that one shorthand for culture is “the way we do things round here”. Explicitly setting out what we, as a firm, want our culture to be; and assessing how individuals’ behaviour stacks up against that. What might an assessment – a moral or ethical audit - look like for financial firms, a parallel to finance and risk audits?

Any such exercise might uncover a problem of lack of shared values against which to do the appraising. But that is exactly the discussion that needs to be worked through. They might also address the incentive structure – is a right, helpful, healthy to incentivise staff in the way banks do?

3 Individual

Just as firms cannot claim ‘billiard ball’ moral amnesty for their decisions, neither can individuals.

Christian insight will never let us get away with the comforting belief that the problems are simply ‘out there’; “a market issue”. They lie closer to home, and conscience demands that we face our complicity. We don’t just observe financial empires; we contribute to them and benefit from them.

I’ve been causing a frisson of unease at some City functions over the past year by asking the speaker and those present what they wish they had done and said differently over the past 15 years, knowing what we know now. Try it sometime. The question of personal responsibility lurks close by – will I admit that ‘the market’ is, in part, me?

We faced these questions head-on at our early-morning prayer meeting in my local congregation early last year. An investment banker then prayed: “Lord, forgive me for my greed; when I’ve wanted more and haven’t needed it.” That simple prayer cut through my threadbare defence: “I’ve mostly been a public servant in the Bank of England. I’m a long way
from rapacious private sector banking.” Get real; my wages are higher as a result of the ‘long boom’ in the financial sector. And the greed of my heart is revealed by my day dreams of higher bonuses, a paid off mortgage, and (dare one still say?) early retirement. So I too repent of my greed.

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Andy Brookes, March 2010