Introduction

In the *Politics*, Aristotle tells the tale of Thales the Milesian. Thales is one of the first philosophers. Bertrand Russell even goes so far as to write that 'Philosophy begins with Thales.'[1] But he could equally have written 'Finance begins with Thales'; for Thales was an early option trader. The fragment from the *Politics* where Aristotle recounts Thales's story is one of the oldest sources to mention option contracts. Predicting a rich olive harvest, Thales spent a small amount of money to buy the exclusive right to use the olive presses; and when his predictions turned out correct, he sold the right to use the presses to the owners of the olive yards, with a nice margin.

Aristotle thinks it was Thales's intention to show the world that philosophers can effortlessly become as rich as other people, but that because their ambitions lie elsewhere, they generally do not end up very rich, which sounds all very good. But wasn't Thales the first speculator? With a carefully orchestrated media campaign entitled 'Banks: Profiting from Hunger', Oxfam International calls on banks to stop speculative trading in food commodities. Food speculation is quite similar to what Thales did, even if Thales's financial innovation might today be more aptly called a *lease contract*, involving as it does the use of particular assets, whereas food speculation is about the assets themselves, the olives not the presses. Oxfam condemns such activities in unequivocal terms. *Food Speculation: A Matter of Life and Death*, a film lasting only fifty-eight seconds, explains why:

> Speculation with food commodities causes the price of corn, wheat and rice to skyrocket. Millions of people in poor countries are being driven into hunger and poverty. Stop gambling with food – curb speculation![2]

[1] Russell, *History*, 3.
[2] www.oxfam.org/en/grow/video/2012/food-speculation-matter-life-and-death.

What we now call the *global financial crisis*, in 2008 we still called the *credit crunch* or *subprime meltdown*. It is true that the year 2008 marks the collapse of Lehman Brothers as well as the rescue of Bear Stearns, Northern Rock, Merill Lynch, AIG, Wachovia, Fortis, Lloyds, Royal Bank of Scotland and others. The enormous recessional increase in unemployment, however, was still far ahead of us, and trust in banks in the United States was still at a stunning 69 per cent, according to the renowned Edelman Trust Barometer. Predicting a prolonged recession would have landed you in a pessimist minority camp. It cannot be denied therefore that the Dutch Bankers' Association realized the significance of the 2008 events remarkably quickly. Lehman Brothers had barely collapsed when a committee led by a respected former banker started an investigation and published its results only a few months later in a report entitled 'Restoring trust'.[3] With its exceptionally concrete suggestions, the report did not fail to have impact. The Banking Code, published in September 2009, which has been effective as a code of conduct under civil law since January 2010, is a form of self-regulation springing directly from that report. The worldwide novelty of a Hippocratic oath, which bankers and other financials have to pledge, was suggested by the committee.[4] Moreover, the report gave a serious boost to the development of regulation requiring the financial services industry to refocus on the interests of its clients.

Yet it is only a very natural question to ask: has this report succeeded in realizing the goal encapsulated in its title? Has consumer trust in finance been restored? Before answering this question, it is important to see that, excepting the eccentric idea of an oath for bankers, the committee's attempts are by no means unique in the world. Restoring trust in banking and finance has been the avowed goal of many government and industry committees around the globe. The US Financial Crisis Inquiry Commission Report, published in January 2011, is perhaps the most famous example, but the Turner Review (2009) and the reports of the Vickers Commission (2011) in Britain and the De la Rosière report of the European Commission (2009), among many others, have largely parallel aims.

[3] Advisory Committee on the Future of Banks in the Netherlands, 'Restoring trust'.
[4] Anderson and Escher, *The MBA oath*, is another well-known initiative.

Trust and trustworthiness

Consumer trust in banks in 2008 was, as stated, 69 per cent in the United States. In Europe it was lower, at 56 per cent in the Netherlands and 47 per cent in the United Kingdom, for example. But five years later it had declined across the board, as witnessed by figures of 49 per cent in the United States, 31 per cent in the Netherlands and a quite scarifying 22 per cent in the United Kingdom.[5] There is no way to escape the conclusion: trust has declined. Restoring trust has totally failed so far. But this statement may be unduly hasty. The figures have to be interpreted with care, and when trust has left on horseback, it will only return on foot. Perhaps banks need more time. Besides that, we must distinguish between general trust in the banking industry and the trust people place in the bank they bank with. If distrust were as widespread as the statistics claim, many people would keep their money under the mattress. This is something they seem to avoid doing.

More can be gained by looking closely into the concept of trust. Trust, to begin with, is a relation. Mary trusts John. Mary trusts the bank. Person X trusts person or organization Y. The truster and the trustee are not the only elements of the relation. Mary trusts John with something – with the car, for instance. And Mary does not trust John with something else – the dog, for instance. A third relatum is, in addition to all this, the sort of actions Mary trusts or does not trust John to perform. Nor is that all. As Onora O'Neill observes, we are particularly interested in placing trust 'intelligently', and that requires the truster to have good reasons to trust the trustee.[6] Mary trusts John with the car but not the dog because she knows John is a careful driver but not a canophilist.

The observation that rightly placed trust requires good reasons immediately directs our attention to a concept that is probably even more important: *trustworthiness*.[7] Mary trusts John with the car on account of her having reasons to believe that John is trustworthy with the car, but she does not trust him with the dog because she has evidence that with respect to pet sitting he is untrustworthy. For banks and bankers to restore trust, then, requires first of all that they regain their

5 Edelman Trust Barometer 2013.
6 O'Neill, 'Trust, trustworthiness, and accountability'. Also see Manson and O'Neill, *Rethinking informed consent in bioethics*.
7 For a brief summary of O'Neill's position, see www.bbc.co.uk/news/magazine-20627410.

trustworthiness. This is not mere wordplay. Take the idea of a Hippocratic oath for bankers, or the MBA oath developed by Harvard Business School graduates several years ago.[8] To claim that an oath will help restore confidence among consumers throughout society is to claim something that has great initial plausibility. But to claim that an oath will raise the trustworthiness of bankers or general managers betokens a naive sort of optimism concerning the behavioural effects of oath taking.

If I had to summarize all this in two words, they would be: trustworthiness first. A frequently used way to analyse trustworthiness is that it depends on two things, namely, the trustee's motivation and the trustee's competence. Take medicine. What makes a GP trustworthy? First, the doctor has to be motivated to help. Physicians primarily interested in their yachts or the amount of money they earn per hour will *ceteris paribus* be less trustworthy than doctors motivated by care, concern for their patients' wellbeing, altruism and other related values. Yet motivation is insufficient on its own. Trustworthy physicians are also competent. They are capable of making an accurate diagnosis. They know the side effects of the drugs they prescribe. They recognize the boundaries of their own capacities and refer their patients to specialists whenever necessary. They see to it that their knowledge is up to date. A trustworthy medical practitioner, in sum, is both motivated to help and competent to help.

The analysis of trustworthiness in terms of motivation and competence is attractive thanks to its elegant simplicity; it is also a vantage point from which I can describe the contribution of this book to ethics and finance. So far ethicists have almost only focused on things that have to do with motivation. Corporate social responsibility, corporate citizenship, stakeholder theory, ethics management, the triple bottom line of people, planet and profit: all are concerned with ways to describe, explain, understand, curtail or improve the motivations and intentions of managers and employees or of entire business organizations. That these ethics models are themed around motivation is probably not a controversial observation. What these models do, perhaps with the exception of ethics management, is to provide ways to call upon businesses to pay attention not only to economic but also other considerations. The triple bottom line adds social and environmental perspectives to mere economic ones.[9] Stakeholder theory opens our eyes to other

[8] Anderson and Escher, *The MBA oath*. [9] Elkington, *Cannibals with forks*.

parties beyond traditional management theory; it shows managers that business affects competitors, governments and civil society, besides the usual four suspects of shareholders, employees, customers and suppliers.[10] To the economic concerns of an enterprise, corporate social responsibility adds the normative expectations that society has concerning its legal, ethical and philanthropic responsibilities.[11] The most recent branch of the tree, corporate citizenship, asks firms to view themselves as partly contributing to the realization of liberal citizenship rights.[12] It is certainly true that these models facilitate competent ethical decision making among managers in that they offer ready-made formulas to determine those concerns of people, organizations or even ecosystems that they must incorporate in their decisions; and initiatives that follow from philanthropic corporate social responsibility or from corporate citizenship may foster competence among many of a business's stakeholders (a much discussed example in this respect is the British retailer Marks and Spencer's 'Marks and Start' programme, developed to help unemployed and homeless people gain experience and work skills).[13] Competence is not presented as a specific theme here, though.

Moral decision making and moral intensity

It is only in the multifarious techniques of ethics management that competence finds a place, however minor that may still be. Ethics management can take many forms, including corporate mission statements, codes of conduct, ethics training programmes, ethical performance management systems, ethics audits, ethics and compliance officers, ethics committees, ethics hotlines, whistle-blower policies and others. More than in the corporate social responsibility model, these management techniques do address manager and employee competence. The theoretical underpinnings of these techniques include a theory of ethical decision making developed by James Rest and a theory of moral intensity developed by Thomas Jones.[14] Rest distinguished four stages of ethical decision making. People first have to recognize the decision problem as one that has a moral dimension to it; they have to see, that is, that their

10 Freeman, *Strategic management*.
11 Carroll, *Business and society*.
12 Matten and Crane, 'Corporate citizenship'.
13 Crane and Matten, *Business ethics*, 77.
14 Rest, *Moral development*. Jones, 'Ethical decision making'.

actions may influence other people positively or negatively. Secondly, they have to form an ethical judgement concerning what ought to be done, which requires them to analyse the situation from a moral viewpoint. Thirdly, they have to establish the moral intention to act in conformity with what they judged, in the previous stage, to be the right kind of behaviour. Finally, they have to engage in that behaviour. Unethical behaviour may result from failures at any of the four stages. People may fail to recognize, judge, intend or behave. Whether they succeed or fail depends on motivation and competence, because knowledge or ignorance may as well influence decision making as weakness of will and feelings of control and responsibility. Competence is evidently related to the first two stages. Who is unable to recognize ethics where ethics exist, or who fails to make competent ethical judgements, will likely fail to act ethically.

Particularly in the context of the financial services industry, a second theme is relevant: the moral intensity of the ethical issue. An issue's moral intensity depends on the magnitude of the consequences of the actions and the probability with which they arise, as well as on whether the consequences are concentrated on a group of people or dispersed among them. Moral intensity also depends on whether there is any social consensus about the fact that particular actions are good or evil and whether the consequences and/or people affected by the actions are socially, culturally, psychologically, physically and temporally close to the agent. Roughly speaking, when evil consequences are likely or severe, affect people in close proximity or a large number of people, and when the agent rightly or wrongly perceives this to be the case, then the issue's moral intensity is high.

As Jones convincingly argues, the moral intensity of an issue determines how people proceed at each of the four stages of ethical decision making. Issues with high moral intensity are more frequently recognized as moral issues, they will lead to more sophisticated forms of moral judgement, and they will more often trigger people to form moral intentions and engage in ethical behaviour. This is relevant to ethics management in banking and the rest of the finance industry because unlike the oil industry, the pharmaceutical industry and the nuclear industry, among others, the financial sector's main ethical issues often involve such high levels of detailed technical understanding and detached engagement that their moral intensity is likely to be perceived as rather low. The prototypical image of traders working in front of several computer screens illustrates the point: they are unaware of the consequences of their number-crunching sales techniques. Empirical studies of moral intensity in banking are, to my knowledge, absent, so we should tread carefully here; in my view, the hypothesis just ventured has much to recommend it. The consequences of investment decisions are often remote and they are dispersed over many people. Probability estimates are typically hard to make. Moreover, the technical character of the issues involved means that consensus is often absent.

Trustworthiness will hardly grow where people do not notice ethical issues, and to notice them, they need competence. The sort of competence that is central to this book, however, is not this sort of *ethical* competence. Recall the doctor. The trustworthiness of doctors depends on the extent to which they are able to recognize and judge ethics and deal with hard cases involving informed consent or conflicts of interest. Thinking of the competence of physicians, however, one typically thinks of their suturing skills and knowledge of intestinal disorders, or something like that. It is the analogue of these sorts of skills and knowledge in finance that I am interested in here, for two reasons. One is the surprising dearth of such competence in the financial sector; another is a recent development in philosophy arising out of a rapprochement between ethics and the theory of knowledge: the theory of *epistemic* virtues.

Motivation or competence?

A lack of motivation rather than a lack of competence is still seen as the primary moral determinant of the global financial crisis. Titles such as Alex Brummer's *The crunch: how greed and incompetence sparked the credit crisis*, David Faber's *And then the roof caved in: how Wall Street's greed and stupidity brought capitalism to its knees* and William Fleckenstein's *Greenspan's bubbles: the age of ignorance at the Federal Reserve* may suggest a view focusing both on incompetence (stupidity, ignorance) and on lack of motivation (greed, etc.). But the emphasis in these and similar books overwhelmingly lies on motivation, not competence. And lack of competence there is. First, among customers. Many people across the world have limited knowledge of financial concepts. About a fifth of adult citizens in Britain are unable to understand compound interest, and consequently fail fully to grasp such simple products as a savings account. Generally, levels of *financial* *literacy*, as it is called, are low, and the lower they are, the less likely it is that people will engage in decent financial planning. American house owners with little knowledge of finance are more likely to face problems repaying their mortgages, not because they may have been saddled with a potentially inappropriate mortgage, but because of issues independent of the terms of the loan.[15] Nor do many people seem to be very interested in acquiring a knowledge of finance. Though it may take weeks for a family to decide on a new kitchen, many people do hardly any research into optimum mortgage terms, often with predictably subprime outcomes.[16] In the vocabulary of epistemic virtue theory, customers often show little curiosity, inquisitiveness or love of knowledge.

But epistemic vice can be found among others than customers alone; among tax professionals, for instance.[17] Tax professionals provide advice concerning the tax returns of business organizations, estimating the probability that if a court of justice had to decide, it would rule favourably. The search technique is disarmingly simple. The professionals try to find judicial precedents. But which precedents? It is only natural to expect them randomly to select a set of relevant court rulings, to distinguish positive and negative decisions, and to divide the number of positive decisions by the total size of the sample. In reality, however, these professionals do not take a random sample. They suffer from the *confirmation bias*, a topic studied in psychology and behavioural economics. The sample they select contains a greater than average number of positive rulings, as a result of which the probability estimate is going to be too optimistic, with predictably unpleasant outcomes for the company filing its tax returns. This is the vice of epistemic injustice – that is, of showing prejudice towards evidence favouring one side of the issue.

Lack of competence is sometimes hard to detect. Consider bonuses, trampled into the mud by many popular writers as a wretched element of a culture of greed supposedly setting the financial sector apart from the rest of the world. The existence of bonuses is typically seen as a prime indicator of an utter lack of motivation among bankers to care for their clients. But a more intelligent accusation relates them not to motivation but to competence. A neat mathematical argument shows

15 Gerardi et al., 'Mortgage default'.
16 Courchane et al., 'Subprime borrowers'.
17 Cloyd and Spilker, 'Tax professionals'.

that when employees receive performance-based compensation, it makes it very difficult if not impossible for their managers to determine whether their professional successes, if they have them, are attributable to skills or to brute luck. Bonuses establish smoke screens between employees and managers, thwarting epistemic virtue and making decent human resource management impossible.

Let me be blunt. Incompetence is likely to be among the key determinants of the global financial crisis. Take mortgage-backed securities, the infamous results of repackaging mortgages, often subprime, with the aim of diminishing risk. Medical practitioners prescribing drugs are expected to understand the risks of the drugs and to have a clear idea of why it is a good idea for their patients to take them; and before taking the drugs, patients read instructions they believe to contain all relevant information, written in ways they can understand. An important form of risk for buyers of mortgage-backed securities is that the borrowers of the underlying mortgages fail to repay them. Some will not repay, but the hope is that this will not happen to all of them, only to a few. The so-called *default correlation* must not be too high.

Credit rating agencies are the main researchers of such risks. They give ratings to bonds and structured debt securities, mortgage-backed securities among them, ranging from top tier triple A to the D of default. When it comes to rating corporate and government bonds, their success rate since the 1920s has been rather impressive; and this is true despite a number of highly publicized scandals (WorldCom, Enron, Tyco, etc.), despite the fact that many economists believe that similar levels of accuracy can be gleaned from much cheaper sources (without the purportedly private information from the issuers that rating agencies claim gives them their competitive edge), and despite the fact that many commentators find that the agencies are embroiled in conflicts of interest arising from the fact that they are paid by the issuers of the securities they rate. Mortgage-backed securities are, however, devastatingly more complex than these plain vanilla bonds. A corporate bond is just a loan to a firm. A mortgage-backed security is a complex amalgam of thousands of house loans structured in fancy yet complex tranches, which makes them more difficult to rate. The rating agencies proved unequal to their task. It was necessary for Moody's, one of the big three rating agencies, to witness the first outbursts of the subprime meltdown to realize that in order to rate mortgage-backed securities it ought to obtain information about what in reality are only the simplest indicators of a mortgage's credit risk, such as its loan-to-value ratio, the credit score of the borrower and the borrower's debt-to-income level.[18] Up to then, Moody's had not found it opportune to examine more than only the *average* mortgage, which contains barely any relevant information at all. It is not surprising, consequently, that Moody's and other raters were later unmasked as twenty-first-century 'alchemists' turning securities with underlying assets of very low, near-junk ratings into gilt-edge triple As.[19] But the consequences of their unconcern for epistemic virtue should not be trivialized. What was rated as gold would have been in much smaller demand had it been rated as junk. As economists phrase it, investor appetite for structured debt securities was significantly increased by the favourable ratings the products obtained from the major rating agencies.[20] No one claims, of course, that the global financial crisis should be attributed to the rating agencies only. That they played a fundamental role is, however, hardly deniable.

Finally, Bernard Madoff. Way ahead of his time when he introduced computer technology in the financial world, he helped set up NASDAQ, the world's first electronic stock market; gained a reputation as one of the biggest market makers on Wall Street, maintaining close connections with supervisory authorities and, until recently, possessing an impeccable status; but behind bars now, guilty of running the largest Ponzi scheme ever. Madoff claimed to be using a penny-plain split strike conversion method merely involving a basket of around thirty-five shares from the S&P 100 index, plus some buying and selling of options or treasury bills. Such a strategy should not be expected to deliver dazzling results; and the returns were indeed not very spectacular if one looked at them month by month. Madoff claimed, however, a yield of about 10 per cent per annum, with only 3 per cent volatility. For split strikes, such figures (it does not matter much now what they exactly mean) are out of the ordinary. With the benefit of hindsight, we can now explain how Madoff arrived at his claim. He was not investing; he was unscrupulously using the money brought in by new depositors to pay the earlier borrowers their promised 10 per cent. That is why he was in

18 J. Mason and J. Rosner, 'Where did the risk go? How misapplied bond ratings cause mortgage backed securities and collateralized debt obligation market disruptions' (2007), papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475.
19 Benmelech and Dlugosz, 'The alchemy of CDO ratings'.
20 Pagano and Volpin, 'Credit ratings failures'.