"OEconomicae et pecuniariae quaestiones" and Catholic Finance : A reading attempt from Merton's functions

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"*OEconomicae et pecuniariae quaestiones*" and Catholic Finance : A reading attempt from Merton's functions

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Abstract: The Church has published a text of reference related to finance titled "OEconomicae et pecuniariae quaestiones," which aims to point out the weaknesses of the financial system and propose solutions. In order to test these remarks, we distributed them in Merton's (1995) functions for the financial system and verified whether these critiques actually challenge them. We found that the Church focuses its criticisms on the functions of risk management and conflicts of interest, and recommends being vigilant about the information function. Finally, by grouping the solutions, there emerges a coherent and complementary approach to the financial system based on the transparency of information.

1) Introduction

The Church published "OEconomicae et Pecuniariae Quaestiones"[2] (OPQ) on May 17, 2018. It is the first substantive text on finance that has been validated by such ecclesiastical authorities[3]. Archbishop Turkson (2019) said that this document was intended to highlight "the weaknesses" of the financial system, which were obvious during the financial crisis of 2008. What are these weaknesses perceived by the Church and what are the recommended solutions? These solutions of the Church are all the more important as they can be applied from the perspective of the expected financial crisis in the aftermath of the COVID-19 health crisis.

Though inspired by the Catholic Social Encyclical, OPQ is close to a note from the Pontifical Council for Justice and Peace (2011) then chaired by Archbishop Turkson. This note briefly explains the financial crisis of 2008 and sees it as an opportunity for change in worldwide governance. It emphasizes that the stability of the financial system can be seen as a public good and therefore must be guaranteed. It advocates the emergence of a global political authority serving the common good by issuing recommendations on how to proceed and what is at stake. OPQ, on the other hand, approaches finance more generally and goes beyond the causes of the crisis. It consists of two parts: the first adopts a normative approach to Catholic finance and the second discusses application of principles and practical

[1] EBS-Paris / INSEEC U

[2] « OEconomicae et Pecuniariae Quaestiones. Considerations for an Ethical Discernment Regarding Some Aspects of the Present Economic-Financial System

[3] The Prefect of the Congregation for the Doctrine of the Faith, Bishop Luis F. Ladaria, and the Prefect of the Dicastery for promoting Integral Human Development, Cardinal Peter Turkson, signed the document, which was also approved by Pope Francis.

guidelines. This second part has been the most commented on since the publication of this text.

The release of OPQ did not result in complete adherence, which also reflects the difficulty of reconciling different political tendencies and degrees of conservatism within the Church. “Catholic economists” Lauzun (2018) and Naudet (2018) were quick to react to its publication. They both emphasize its importance in the hierarchy of Church texts. Pierre de Lauzun speaks of "a substantive, incisive but well-balanced text" while regretting that it does not insist on the indebtedness of economies and virtues of investing in equities. Jean-Yves Naudet goes further in his analysis. He enumerates the technical points mentioned in the text, while distancing himself from their critical content and calling on potential readers of this text to consider these aspects with "openness." French journalists (Chambraud, 2018; Senèze, 2018)[4] considered this document to be a strong critique of finance. Practitioners[5] have tended to be quite severe with this text, which has overlooked part of their efforts, especially in the area of ethics. The text also does not address Catholic initiatives, especially at the product level.

Garello (2018) and Feldman (2018) investigated the degree of liberalism of the text and its consistency with the Social Doctrine of the Church. They found many ambiguities; Feldman (2018), in particular, is very severe toward OPQ’s recommendation of regulating the financial market. In a similar vein, Delsol (2018) recalls the antagonism that may exist between civil law, moral law, and the market economy.

Nevertheless, this text presents a global approach to finance from the perspective of the Church. We seek to determine the weaknesses of the financial system identified by OPQ as well as its practical recommendations. The financial system as such is not called into question by this text. However, as it points to weaknesses, one wonders about their relevance, especially with regard to the objective to be achieved. Further, even though the Church denies having a financial model (Booth, 2014), what global vision of finance She suggests through the solutions proposed in the text? To answer these questions, we confront these weaknesses with the functions that the financial system should perform according to Merton (1995), and examine whether the document calls into question any of these functions. We then bring together the proposed solutions to try to extract a global vision.

Through our approach, we find that the problems raised by the Vatican relate to the functions of allocation, risk management, information, and conflict of interest resolution. Rather, it questions the last three functions. The Church proposes responding to these dysfunctions with a complementary and coherent approach to finance. This approach consists of renewing the regulation of financial activities, inspired by ethics in the service of human life and the common good. It also supports total transparency of information, which should make it possible to reduce the asymmetry of information, in order to not only balance the relationship between the financial intermediary and the investor, but to also make the latter more responsible for his actions.

[4] Agence France Presse [2018], » "La finance mondiale clouée au pilori par le Vatican" 17/05/2018
[5] Des économistes réagissent à « Œconomicae et pecuniariae quaestiones », La Croix 17/05/2018

Following this first section, a second one reports on the weaknesses of the financial system as identified by the OPQ. In the third section, we bring together the solutions and the fourth section presents the conclusions.

2) The weaknesses of the financial system perceived by the Vatican

The weaknesses in the financial system identified by the Church relate mainly to activities attributed to the financial system that may have affected the common good. If the role of the financial system is recognized by the Vatican, one can wonder about the relevance and contribution of these remarks on its effectiveness. Merton (1995) proposed breaking down the role of the financial system into six basic functions. We chose this approach because it is easily generalizable. We distributed all the text remarks among these functions and checked whether any of them were called into question. Out of the six functions, we considered that the document did not address the functions related to means of payment and fundraising for the financing of large projects. Therefore, we distributed the text comments around the following four functions.

Function 3: "*A financial system provides a way to transfer economic resources through time and across geographic regions and industries*"

Regarding the transfer of economic resources through time, OPQ emphasizes "the irreplaceable social function of credit," while condemning excessive usury rates. As for the transfer of economic resources across space, it recalls the unprecedented increase in economic well-being, but denounces the level of persistent poverty of individuals and countries and the growing gap between the richest and the poorest. This situation persists and worsens, in particular, because of offshore financial sites and the greater mobility of capital. The offshore financial sites facilitate capital flight on grounds of tax evasion or illegal activities. They attract considerable amounts of funds from profitable activities seeking to escape excessive taxation in some states. They also help to launder dirty money. Moreover, states that are often among the least developed have increased their debt for the benefit of a privileged minority who has been able to transfer its funds to these tax havens. In this sense, this document considers that offshore systems and the supranational dimension of financial markets aggravate the debt of states. These resources are therefore withdrawn from tax revenue and diverted from the real economy, while they could have been invested or redistributed to serve the common good. Finally, OPQ considers that too much capital is being diverted from the real economy toward high-frequency trading for the purpose of speculation.

Thus, the Church does not really question the effectiveness of this transfer function, but is quite critical of the distribution that results from this transfer of economic resources across space and certain means that facilitate it.

Function 4: "*A financial system provides a way to manage uncertainty and control risk"*

Offshore financial centers or shadow banks escape the regulations applicable to the traditional banking system while being opaque. They have allowed the appearance and development of products whose morality[6] is questionable and which can harm the economy as a whole. Among the products mentioned in the document are Credit Default Swaps, which are "immoral by nature" or "morally negative" to the extent that their concept is tantamount to betting on the bankruptcy of others. The risk could be marginal for the common good if the amounts involved were not so colossal. In doing so, financial intermediaries have been able to issue risky securities (subprime) with a fictitious value to generate profit while transferring the risk to the purchasers by means of securitization. Further, the complexity of such products makes it difficult to not only estimate the risk but also its value. It is in this context that a few individuals can disrupt the economy as a whole and affect the common good by excessive risk-taking.

Finally, OPQ describes a process that encourages not only distancing from the application of ethical rules, but also risk-taking within financial firms. On the one hand, ethical standards can be "perceived as irrelevant and juxtaposed to the entrepreneurial action" and therefore not integrated into the corporate culture. On the other hand, these companies tend to appoint unscrupulous individuals to positions with responsibilities who favor short-term solutions to maximize profits, to the detriment of stakeholders. This process encourages risk-taking since premium/sanction arbitration in case of failure is asymmetrical and favorable to the premium.

According to these elements, this function is not ensured, especially as risky behaviors are self-generated by the financial system and do not emanate from a few individuals. The document therefore calls into question the ability of the financial system to manage risks both at the product level and at the level of banking institutions with their systemic dimension.

Function 5: "*A financial system provides price information that helps coordinate decentralized decision-making in various sectors of the economy*"

OPQ severely condemns the LIBOR[7] scandal and the manipulation of reference rates, which are important financial information. Conflicts of interest also affect the quality of information, as is the case with rating agencies. The latter are not sufficiently impartial in their estimation of the risks related to companies that are also their clients. These information "distortions" undermine the objectivity of the choices made by investors. They also add to the complexity of certain financial instruments and the subsequent difficulties in understanding them to objectively apprehend their value.

The Church also warns against the development of economic entities that amass information. In such a dominant position, they can influence the prices, rules, and policies at the same time. In this regard, OPQ refers to speculative manipulations or attacks that are

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[6] On the basis of this text, although the immorality of a financial product depends in particular on the information asymmetry between its seller and buyer, it also depends on the conflicts of interest it contains and the risk it entails for the common good.

[7] From 2006 to 2009, major banks misled investors on the setting process of the reference average rate LIBOR.

organized by investors who take advantage of their dominant position and can harm the common good of a country or region.

In the context of this coordination function through information, the text repeatedly refers to a lack of transparency and dysfunction in the establishment of prices. It does not say that markets are inefficient, but it does warn against the possible manipulation of certain information.

Function 6: "*A financial system provides a way to deal with the asymmetric-information and incentive problems when one party to a financial transaction has information that the other party does not"*

We also embed criticisms of the document regarding the country's institutional governance problems. The over-indebtedness of some countries can be explained in particular by the absorption of many private debts by the public sector that have been contracted by privileged individuals supposedly serving the common good. It is the people of the country in question who bear the burden of the debt.

Similar to Function 5, one can mention the conflicts of interest related to rating agencies or the LIBOR scandal. To these conflicts of interest can be added those resulting from financial innovation, which causes more complexity while increasing the degree of information asymmetry and thus more uncertainty about the objective value of the purchased security. In so doing, the Church questions the principle of caveat emptor[8] to establish the responsibility of a seller or financial adviser in the transaction. Similarly, the Church highlights the case of mutual funds that collect the savings of small holders while increasing the turnover of investments without justification, in order to incur higher management fees. More generally, the Church believes that one should not "take advantage of the lack of knowledge or the contractual weakness of either counterpart."

Several conflicts of interest are illustrated in OPQ, demonstrating that the system allows them to exist while condemning them. These conflicts most often arise due to problems of information asymmetry that put one party at a disadvantage in relation to the other, or because of an asymmetrical balance of power. The Church states that situations of conflict of interest must be resolved in order to preserve the confidence of savers in the financial system. Moreover, the Church denounces the interests of a few who are opposed to the common good.

This classification allows us to synthesize OPQ and reinterpret it through the functions of Merton (1995). Of the six basic functions that a financial system must ensure, the Church addresses four. Through its remarks, it shows that the financial system does not manage its risks well enough and that it still needs to improve its management of conflicts of interest. The financial system is also encouraged to be vigilant with regard to market efficiency and to limit the information asymmetry that generates inequitable situations. Further, it does not put into question the transfer of resources through time and across space, rather the way

[8] caveat emptor: Latin expression meaning "let the buyer beware."

in which these resources are distributed and concentrated. We next consider how the Church proposes to resolve these weaknesses.

3) A complementary vision of finance by "OEconomicae et pecuniariae quaestiones"

Some solutions are attached to the "weaknesses" stated by OPQ, and are addressed to managers, practitioners, and users of financial services, without however commenting on the measures taken since the 2009 crisis. They are approached in a disjointed manner in the text, but as we group them together, it is shown that they can be conceived as a coherent complement to the current financial system, aiming to protect the common good and the most "vulnerable." We will therefore bring these measures together by distinguishing suggestions relating to the governance of the financial system and ethics from those relating to the proposed rules and sanctions. Finally, we will show how transparency of information lays at the foundation of this complementary vision.

A renewed regulation inspired by ethics

OPQ postulates that the markets cannot regulate themselves because of the immoral conduct of some financial actors, and shows that the financial system leads to possible behaviors that it condemns. Drawing on the experience of the preceding financial crisis, which could not be avoided, the Church suggests a renewal of the regulation of financial activities that would serve the common good. This regulation must be able to combine, at the same time, the freedom and protection of all actors, especially the most vulnerable. However, several conditions must contribute to its effectiveness. It should be inspired by ethics and be able to enforce them.

The ethics recommended to guide this regulation of the financial markets must be attached to anthropological and moral foundations and, in particular, be inspired by the social doctrine of the Church. These ethics must ensure respect for human dignity and orient human activity toward the common good.

This regulation and its ethical principles should not only be seen as an apparent consent but should be disseminated and adopted by the financial system at all levels. Their application must pass through a stable coordination between the greatest possible number of national market regulatory authorities, which must be independent. Likewise, financial markets must receive directives that are uniform and shared by as many actors as possible. Finally, in order to dedicate this regulation to the common good, the separation of political, economic, and financial powers must be respected.

This system therefore must be convincing and disseminated. The document recommends setting up ethics committees alongside the boards of directors of major banks and other financial institutions in order to disseminate and enforce ethical rules through internal compliance functions. This function must be legitimized and promoted within the company, so as not to limit its action to simple rules and controls that can be circumvented and only formally admitted. This dissemination should be undertaken in turns by business schools and universities by integrating it into their curriculum.

Enforce the regulation and the rules derived from it

If communication and pedagogy are not enough to enforce this regulation, then the rules must be sufficiently dissuasive. The Church stands out in this respect for its insistence on greater severity and believes that sanctions should be much more "proportionate" in relation to the premiums for fraud, in order to avoid the immoral behavior of a few. Fraudsters should also be punished out of their personal assets. The Church also believes that consulting activities which circumvent the standards in force are to be considered illegitimate and each party involved should be penalized.

This willingness to sanction is taken up again with regard to countries that organize offshore financial services and allow laundering of dirty money collected through illegal activities or tax evasion. These countries should be penalized by "incisive sanctions" in order to end their activities[9]. This would contribute, in particular, to the partial resolution of the problem of over-indebtedness of some of the poorest countries. In this regard, the strongest institutions should consider debt relief for countries that suffer the most from debt distress.

Information as the keystone of the catholic approach

The Church presents information as the keystone of its complementary vision in order to reduce the degree of information asymmetry which benefits some parties to the detriment of other disadvantaged ones. The information therefore must be "totally transparent." Information transparency would allow a virtuous circle in which the authorities would be able to better control the market and the users of financial services would be able to make informed, fairer, and more responsible choices. We would, however, point out that total transparency implies not only greater completeness of information, but also better quality and more simplicity.

Information, both that is submitted to the authorities and that is provided to the users of financial instruments and services, must be transparent and as complete as possible. The Church wishes to extend information transparency to the ethical content of the financial instrument or service while establishing more equity in the exchange. This implies that the investors or savers should know if the funds they deposit are being used for speculation or if the institution is taking excessive risks. In this regard, the Church recommends the separation of the activities of deposit banks and investment banks. Likewise, the investor must know whether the companies in which he invests practice tax avoidance.

The information must also be reliable and of better quality. Information providers or market makers must offer better quality services. This implies that any misleading manipulation of information, as in the case of the LIBOR scandal, must be severely sanctioned. To avoid conflicts of interest related to rating agencies, OPQ suggests that they should be subject to "public regulation" while assessing their operations in an impartial manner. The Church

[9] While striving for the interruption of the offshore sites' activities, the document proposes that if tax circumvention were to continue, one could envisage a "minimum tax on the transactions accomplished offshore would be sufficient to resolve a large part of the problem of hunger in the world." Although the press has insisted on this point, we highlight that this solution is detached from the model and is only a transitory alternative.

also recommends the provision of legal instruments that can sanction "wrong actions" in the field of rating and prevent the creation of oligopolies[10].

It is also by simplifying information that the terms of trade will be more equitable and many conflicts of interest could be dissipated. The purchaser of a security must be aware of what he is buying in several respects. The complexity of a financial commodity cannot be a pretext for diluting information and consequently not allowing for a reliable assessment of risk.

Whatever the process, the purchaser must not find him/herself in an unbalanced situation that would disadvantage him/her in his/her ability to defend his/her interests. He/she must also be aware of the existence of conflicts of interest inherent in the product itself. Finally, the text calls into question the principle of caveat emptor, the reciprocal of which implies that the seller of the product is responsible for its defects. Nevertheless, it is also recommended that the authorities should not only control but also approve financial innovation in order to limit the threat to the common good posed by certain financial instruments such as Credit Default Swaps qualified as "morally unacceptable."

Finally, the complete transparency of information and the greater reliability of both information and relations with financial intermediaries should make it possible to readjust the balance of power. In fact, it creates a virtuous circle from the downstream, where the investor can choose to orient his savings toward more ethical support and processes. The investor is responsible for his/her act of investing and thus becomes an incentive. The document speaks of "voting with one's portfolio."

Considered together, these various suggestions take the form of a coherent complementary approach by proposing solutions upstream and downstream of the financial system. The Church proposes the renewal of financial regulation with anthropological and ethical foundations, which are supported by a stronger and more convincing coercive mechanism. In addition to these aspects, this approach is based on complete information transparency. The information must be of better quality, more exhaustive, and more straightforward in order to rebalance the relationship between financial intermediaries and investors. Moreover, it allows the investor to be involved and held accountable. This model is coherent and supports strong hypotheses, insofar as it would be adopted by a majority of countries and financial authorities such that they would be able to impose it on other players, especially offshore markets. However, from an economic point of view, complete transparency of information may not be desirable and may appear to be in contradiction with greater simplicity.

4) Conclusion

We have examined the weaknesses of the financial system and the proposed solutions

[10] The main problem with rating agencies is a conflict of interest where the rated companies are those who also pay the agencies. Moreover, three rating agencies hold 95% of the global market share.

outlined by the Church in "OEconomicae et Pecuniariae Quaestiones." We investigated which functions of finance were concerned with these remarks and whether they were called into question. We also gathered the proposals made by the Church in order to present them as a complementary approach. We observed that the points of weaknesses mentioned by the Church indeed called into question three functions of finance. The Church targets difficulties related to the functions of financial risk management and conflicts of interest. It also warns against information asymmetry and distortions affecting the efficiency of the markets. We have also highlighted a coherent and complementary approach to finance, where financial regulation is inspired by anthropological and ethical foundations at the service of the common good. In this framework, the Church is distinguished by its severity toward those who would circumvent the rules. Moreover, its approach is based on the assumption of complete transparency of information. Information should be of better quality, easier to interpret, and extended to its ethical content, in order to balance relations between financial intermediaries and investors. The latter must be responsible and become actors of the financial system in the ethical orientation of their savings.

This document presents proposals that are somewhat audacious. It would then be interesting to try to demonstrate whether they would actually improve the financial market. An extension could also be considered to compare it with sustainable finance.

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