# The Ethical Dimensions Of Financial Crisis In The World Of Globalized Finance

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## Introduction

The conclusion by the Financial Crisis Inquiry Commission in respect to the financial crisis of 2007–2009, in their report was, there had been a "systemic breakdown in accountability and ethics" (FCIC, 2011). The global financial crisis and its aftermath, the global economic crisis followed by global recession have raised pertinent questions in appraising theories and practices in more than a few areas. An intently technical view of the proceedings reflects on the predicaments to be, in effect, one of the severe flaws in the financial sector. The broad view, on the other, looks upon the problem as an unethical behavior by several participants in the financial sector as a whole (Reddy, 2012). According to the commentators on business ethics, the corporate financial scandals and subsequent failures have assumed epidemic proportions and reputed global entities have been brought down by the misdeeds of a few of their distinguished leaders. In fact, in an extensive point of view, the financial crises were not stayed put within the terrain of US but multiplied gradually throughout the entire world and exaggerated the economic and political instabilities as well. The intensive acceleration in globalization, implementation of advanced technology, increasing competitive stress and initiation for structural revolution has caused stern structural shift in global landscape during economic and financial expansion. It is alleged that during the time of expansion ethical issues are mostly of less consequence and become redundant and eventually ignored in the economic space. Sensitivity to ethics, on the other, gets momentum when economic and financial crises crop up or are gradually deserted. Given this, it can be believed that there is every reason for the existence of diverse nature of ethical issues in finance. In this paper attempts are made to identify some common characteristics of financial ethics, its relation with economic, finance and financial sector. The next section deals with the various causes behind the financial crisis and explores the ethical fundamentals of such crisis. The ethical challenges for today are also raised in order to survive and sustain in this globalized financial environment.

**Ethics, Economics and Finance – the Canvas**

Ethics has been explained as a concept that embodies judgement about right and fair conduct or behaviour (Joyner & Payne, 2002; Carroll, 2000), judgements involving moral decisions as to whether something is good or bad or right or wrong (Velasquez, 2002). Aristotle spoke of ethics in terms of 'the good life' for individuals, achieved through their involvement with the community in which they lived. Theories about ethics have, in general, been classified into one of two categories: deontological and teleological. Where deontological theories focus on the inherent righteousness, the teleological theories, on the other, signifies the level of good or bad consequences of the behaviour (Vitell, *et al.,* 1993). Describing ethics in respect to a business environment, it engrosses a moral appraisal of actions taken in the course of conducting business (De George, 1999). However, with some of the precepts as are experienced in contemporary business practices, these interactive perspectives seemed incongruent. The main reason why ethics in economy and finance are increasingly brought to the agenda is not only an agenda in scientific research but also an important issue for public debate due to the mounting overt unethical behaviours of organisations especially in developed countries and increasing contagion effects of such behaviours. The recent episodes of Enron, World-com and Bernard Madoff in the USA, the scandals of Parmalat in Italy, Siemens in Germany should be regarded as incidents arising mainly from unethical practices of the companies and their management (Akif IÇKE, 2011).

The antecedents of the theoretical connection between ethics and economics go back, at least, to Aristotle who conceived economics as a part of practical philosophy together with politics and ethics. At the beginning of his Nicomachean Ethics, Aristotle places Economics in relation to human ends by referring to the specific purpose of Economics as a set of methods or skills oriented to the objective of increasing wealth (crematistic) (Aristotle, Nicomachean Ethics, Book I, 1953). The key attributes in economics are utility, rationality and methodological individualism and how these attributes are formulated and combined in the decision-making determines different roles for ethics in economics. Amitai Etzioni (1988), Amartya Sen (1987), John Broome and others has also opined on these concepts and hence find different problems and possibilities for a greater role for ethics in economics (Rowen and Dietrich, 2004). This approach to decision-making ignores ethical considerations, only the consequences that the individual faces are considered, and hence the consequences faced by others are not considered. Therefore, the individual is motivated only by self-interest and is not motivated by ethical considerations, such as altruism, sympathy or fairness. Although the choice may be ethical, the individual is not ethical as they act only in their self-interest and are unaware of how their decisions impact upon others. The orthodox economy evolved within the frames of perfect competition, decreasing returns and modeled men as totally self centered, despite the fact that real persons do not behave that way (Sen, 1991). According to standard economic theory, individuals are rational and have well defined utility functions that represent their individual preferences, and choose their action by maximizing their utility subject to appropriately defined constraints. Ethics in economics mostly deals with systematic thought of basic logic of economy within its normative conditions and results. For this reason, it is possible to see philosophy and ethics as the compulsory ground and complement of economy (Wallacher, 2009). According to the liberal philosopher Adam Smith, social utility can be maintained if everyone pursues their own self-interests. It inevitably springs to mind that whether the latest financial crisis costing trillions of dollars confutes the said optimistic assumption (Homann, 2007b). Therefore, the knowledge that economy and segments are compulsorily connected with ethics is one of the basic facts.

Ethical concerns, as exemplified in the writings of Adam Smith (Smith, 1976), are fairly at variance with finance theory, which rests on a core assumption of profit maximization or the maximization of shareholder value. In practice many companies adopt policies that appear to sacrifice profits for other objectives including esteem or reputation which would impose undue losses on stakeholders such as customers, suppliers, or employees, who have no contractual power to enforce such consideration (Friedman, 1970). But ethical behavior may not result solely from altruism. It is possible that an ethical stance is simply another dimension in the competitive armory alongside marketing, new technology, or cost management. In this context, it can be considered that competition has the capacity to function almost as a moral value and thus competitive theory in general and economics theory in particular can indirectly become an ethics theory. In the absence of such a framework, self-interest or competition may cause chaotic and subversive impacts (Homann and Klink, 2009). It has been observed in the history of economics that such subversive impacts may even result in the collapse of financial and economic system as a whole.

Asymmetry of information (like insider trading) is another fertile area for ethical concern. These days, individuals spending are not constrained within their savings or real income rather most people make consumption on popular and easily-available borrowed money or pumped money. Financial institutions, specialized in providing such borrowings, are making their sincerest efforts for promoting the developing this transition. The recent phenomena is not only the crisis of banking sector and financial institutions but also shows itself as the catastrophe of a specific human behavior referred to as "consume now, pay later!" (Dahrendorf, 2010). The financial crisis has undeniably demonstrated that the stability and sustainability of free market economy are not secured in itself. The emergence of global capitalism has conveyed several risks that portray completely different characteristics. While some erudite authorities have alleged that government interventions are the only line of attack to salvage the economy, others argued that financial systems must be self-regulating to protect the interest. In this sense, it is more often revealed the idea that an alternative to the traditional banking activity can constitute an antidote to the instability of financial institutions.

## Ethics in the financial sector

This definition of fiduciary responsibility – with its use of the terms "obligation", "trust" and "confidence" – underscores a fundamental and long-recognized truth: ethics is the bedrock of successful financial intermediation and, by implication, of successful financial systems and market economies (OECD, 2010). In the financial sector, deontology is reflected in regulations as promulgated by the Central Banks, governments, and the sector itself. From such perspective, financial sector regulation should be such that it gives a holistic support to the sector, and hence, regarded as just or fair. Regulations, however, become unsuccessful (a) in respect to excessive liberalization of the financial market and (b) worsening control over the banks, moderately through regulatory capture. Without a strong commitment to rules, both in terms of rule setting and rule enforcement, in the financial sector, deontology has limited ethical ability to thwart a next crisis (Bonvin and Dembinski, 2002).

The principal source of investors' trust and confidence, it is believed, is the ability of financial intermediaries to put together credible commitments to a certain number of rules and standards of behavior – as ethics makes trust possible. 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 (Reddy, 2012). However, the recent developments in financial markets have raised some serious questions on the credibility of the policy-makers and attested to the dangers of undermining this ethical foundation of the financial systems. The United Nations Environment Programme's Finance Initiative (UNEP FI) takes a broad look at the relationship between ethics and financial intermediation. The most recurring ethical violations in finance are mainly due to violations of trust and loyalty such as insider trading, stakeholder interest versus stockholder interest, investment management and campaign finance. Other frequent incidences are deceives in financial agreements, bribes and corruption in governments, dishonest accounting of trades and customers profit, illegal transactions, using customer funds for personal gain (Boatright, 2010). It is true that some, though not all, banks were to blame for the predicament, however, the other concern of business ethics such as bribery, corruption, and tax evasion misses the point – the most contagious evils expose for the most part in emerging markets. While there are occasional instances in developed markets, the recent financial crisis was caused as much by governments celebrating continuing economic growth which, with hindsight, was based on excess liquidity. There is a desperate need to improve corporate governance across the world because practices are as varied as those of national regulators and businesses need to develop and implement global standards of best practices (Vitell and Festervand, 1987).

## Facts behind the Crisis

The subprime crisis that embarked on in the summer of 2007 may be ranked as one of the most harrowing global concerns of the last one hundred years. It caused consternation and panic throughout elite circles in developed countries as efforts to reignite resilience in the financial markets were discouraged time and again (Bank of England, 2008). The roots, however, of the crisis can be traced back to the deflation of the high-tech bubble of a decade ago. When the stock markets began a steep decline in 2000 and the global economy started to slide into a recession, the US Fed Reserve and other central banks sharply lowered interest rates to limit the economic damage. Traditionally, banks had financed housing loans mainly through "investment-grade" mortgage-backed securities (MBS) on to investors who were eager for high-yielding investment products in a low-interest environment. Banks themselves had set up highly leveraged, off-balance-sheet, structured investment vehicles (SIVs) to buy and hold some of these securities on their own account in order to maximize returns. Once the era of low interest rates ended, and many of the adjustable rate mortgages were reset higher, more and more borrowers started to default and the crisis began to snowball towards disaster (Jickling, 2010).

There is a universal belief that the global financial crisis in recent times has been the outcome of the problems in the US subprime mortgage market, wrongful acts of the flawed institutions and some unfair practices of the current financial regime, often referred to as the New Financial Architecture (NFA). The obsessive securitized mortgage market and its related derivative products also amplified the flaws of the housing sector, sending a shock wave to the entire US economy and to the rest of the world (Curtis, 2008). Once the securitization process became unravelled, fuelled by defaults and foreclosures of the borrowers, the holders of the securities had to suffer huge losses. The market for the securitized obligations rapidly dried up and risk premiums on them consequently distended out. Moreover, the brokers, realtors, folks in rating agencies, and other market accomplices, continued their efforts in maximizing his or her own gain and passing problems on down the line until the system itself collapsed. Coupled with this was substantial and widespread decline in assets prices, particularly equities, also made the market extremely volatile. The lack of accountability and transparency of activities of these participants, the model of mortgage finance turned into a massive generator of risk. Its complete shutdown shattered the entire US banking and financial system. Matters got worse in September and by November 2008, the entire financial system of the US and the UK became incapable of carrying out even the simplest of the conversion of corporate savings into investment or the financing of home building, personal consumption, or development.

**Ethical Fundamentals for Global financial crisis**

The post global financial crisis has raised two most ethical questions: who is responsible for causing the crisis and who are paying for the damage inflicted. According to the commentators on business ethics, the corporate financial scandals and subsequent failures have assumed epidemic proportions and that once great companies of long-standing history with previously unblemished and even dignified reputations have been brought down by the misdeeds of a few of their leaders (Singh, 2008). These corporate collapses have gathered pace in recent years, especially in the western world, and have culminated in the global financial crisis that the whole world has been experiencing till date. The US Fed Reserve has been accused since 2001 of rapidly decreasing the interest rates and setting the grounds for financial crisis by promoting asset prices booms and setting for extreme risk. The proliferation of new financial derivative instruments, hedge funds and short-run high-rate profits combined with various causes has also led to the collapse in financial markets. Considering that economy has been separated from all other areas of life, it becomes possible to perceive the sickness reflected in the greediness of speculators, managers and shareholders (Kampits, 2009).

The basic functions of the financial sector in the economy are generally comprised of distribution of risks, collection of savings, hedging, financing capital and liquidity realization. However, the sector had not only created risks but intensified them further, rather than managing the risks as desired in social environment. The selfishness and desire to earn more income were embraced by the managers of banking and real estate sectors and fund managers, and also by the politicians, credit rating agencies, regulatory and auditing institutions, media and many small investor who had participated in this “game” had ultimately led the world to recent financial crisis.

Another reason of the crisis was those unfair activities of the lending banks that created high-pitched advertisements for highly misleading mortgage products to ramp up volume of loans and to sell those to less credit-worthy borrowers. These entities were actually those mortgage brokers who were paid big fees to lure a steady stream of suckers into the scheme. According to the loan-disbursing system, loans to less credit-worthy borrowers require more careful background checks, more complex structuring, different legal, collateral and repayment conditions, and so on. As these were not been done that gave the entire sub-prime lending industry a dreadful name. Moreover, some investment bankers in US had deliberately structured some bonds known as Auction Rates Securities (ARS) with the credibility like “safe as cash but with a higher yield”. The idea behind these securities was to create instrument that would have a long-dated maturity but an interest rate similar to very short-term paper. The ethical issue was clear from the outset, but when the going became slightly tough, the banks bailed, leaving their clients in the lurch. The financial firms stood by and allowed ARS auctions to fail, causing issuers to pay rigorous penalty interest and resulting investors’ funds to freeze up.

The Government Sponsored Entities (GSEs) like Fannie Mae and Freddie Mac, an uncanny permutation of private corporations and Federal bureaucracies, whose shares were traded in the public market and their credit was backed by the government. The specific problem was that the GSEs strived to add to their profitability not just by buying loans, bundling them in securities and selling them, but by holding billions of dollars of these mortgages and showing on their own balance sheets. The survival of these institutions came to an end when those loans turned bad and both the revenues and the balance sheets of the GSEs collapsed. The subprime debacle was a perfect example in their ethical role by the GSEs (Curtis, 2008).

It is argued that the most ethical obligation of the financial firms is to make transparent public disclosures. But over and over again it was observed that the optimistic statements voiced by the CEOs were designed to leave shareholders and customers into a superfluous belief of security. Despite frequent and ongoing assurances from Lehman's CFO and CEO that all was well, the firm continued to spiral downward and ultimately went into liquidation in 2008. Moreover they did more disreputable job by lying to the public, to their customers, to their investors, and even to their own employees (Curtis, 2008).

Questions thus generally raised in respect to the role of the globally recognized rating agencies that were mostly responsible in qualifying the subprime credits and securities. It is argued that these specialized entities cannot declaim their responsibility in respect to the subprime crisis as the ratings provided by these trusted entities were found mostly unacceptable and defective. Moreover, they failed to warn of the nuisance ahead because of the vicious incentives created by the business model espoused by the agencies. The idea was that the rating agencies were funded by strong incentives paid by issuers or sellers of securities to have inflated ratings to please their customers. The financial and popular press alike treated the observation that rating agencies were funded by those they rate as a scandalous revelation (Wighton, 2009; Baker 2005). The excessive reliance on ratings was the major discrete criticism against those agencies, which reinforced numerous laws and regulations as a criterion for permissible investments. These securities though enjoyed AAA credit ratings were later found indefensible or unproductive predictors of the actual risks involved with the securities.

**The ethical challenges for today**

The outcome of financial crisis has thrown light on the numerous unscrupulous activities of some self-interested people who not only focus on profit and shareholder value but have undermined the human dignity, freedom and justice. Humanity has lost its astute about crises after two generations, a period which experienced upswings for a long time and then the big crisis which made the things return to the normal. Moreover, the crisis has educated us as a development that would help to readopt more convenient understanding of reality (Woltron and Liessmann, 2009). It is pragmatic that after the financial crisis, criticisms in the public mainly focus on the unlimited greediness and morally misconducts of managers. It is clear that this opinion has supported neoliberalism which is built on the effectiveness of markets (Khalil, 1990). Dissenting authors, however, diverge against the effectiveness of markets. According to them, the efficient-market hypothesis in financial markets is probably one of the biggest and expensive mirages of history of economics (Schuberth, 2008). Under the light of the statements, it is possible to say that the solution is not to prevent self-interest or greediness. It is needed to accept the self-greediness which is a human instinct and guide it for the good of society (Dilk, Gürtle and Littger, 2009).

The basic functions of the financial sector are comprised of distribution of risks, hedging and collection of savings, arranging financial capital and liquidity realization. During the subprime regime, the subprime credits and securitized derivative financial instruments were designed and introduced for performing the destined activities and also to reduce risk. However, the malfunctioning of the financial sector and its instruments, instead of governing the risks further intensified them that had resulted in the financial crisis. It is, however, not judicious to interpret that the financial sector has completely become incapable of risk management. Undoubtedly, it is likely to take better measures for similar developments by taking lessons from the recent crisis. Moreover it is absolutely not to ignore or underestimate the importance of systemic factors causing the crisis. Companies are supposed to be active in the formation of global rules of the game in order to secure an agreed competitive system for their own interest. Societal improvements can only be attained by designing the future with the understanding of globalized societies and development of restrictions for such conditions. It is true that the basic principles of general ethics appropriate to every aspects of human life should be adopted by economy which delineates a moral framework. This designed framework should have mutual commitment and interrelation with the functions of the financial institutions, markets, governments, civil society and multinational companies as well and there must be extensive legal bindings for everyone to regard those responsibilities (Suchanek and Lin-Hi, 2010). However, it increasingly becomes a staid concern that a paradigm shift with an intellectual swing be needed to put the infinite wild capitalism back on the right track. Economy is destined to be in a position to serve human life, to harmonize with social life and to have the capacity to meet the needs of existence. The said mental shift is more important than all subsidies maintained by government to save institutions in dire straits (Kampits, 2009). The big challenge for the responsible global corporate entities is to survive and sustain in the economy by rationally overcoming this contradiction without being the object of competitive disadvantages. Thus, the corporate entities should usher a fair competition globally. Actually, the solution lies in the inhibition of said self-interests through embedding self commitment, i.e., to commit the self for the self interest accomplishment in the long-run (Lin-Hi, 2007).

The adverse outcomes associated with financial globalization are part and parcel of a global system that generates systematically unfair outcomes. This unfairness, in turn, is rooted in structural inequality that locks most nations in the developing world into slower rates of income growth and higher poverty levels than would otherwise be possible (Dymski and Kerstenetzky, 2008). The point is also often made, with evident justice, that it is impossible to have, in the foreseeable future, a democratic global state. This is indeed so .. [but] we need not put the possibility of global democracy in indefinite cold storage. It is not an "all or nothing" choice, and there is a strong case for advancing widespread public discussion, even when there would remain many inescapable limitations and weaknesses in the reach of the process (Sen, 2006).

## Conclusion

The evidence from the World Economic Survey (as conducted in various countries, including France, Germany, India, Indonesia, Israel, Mexico, Saudi Arabia, South Africa, Turkey and the United States) and also the available literature have established that a lack of or absence of ethics and values was at the root of many of the problems facing the global community today (Baxter, 2010). Amidst a crisis where no one knows how bad things can get in today's unpredictable global economy, where there is no straight solution to problems facing humanity, one thing is clear: we should aim at preventing further crises of an economic and social nature (Friedman, 2009). Moreover, there requires greater accountability from the corporate leaders to re-think their approach in interacting with the global scene (Smick, 2008; Thompson, 2005). The new facet to accountability calls for a wider ethical dimension and increased interaction with global business partners from varying cultures with increased risk for greater ethical conflicts (Hagan and Moon, 2006). With global business and rapidly evolving technology there exists the risk for ethical conflict that can significantly damage stakeholders' relations. An organization that fails to manage internal conflicts runs the risk of ruining its reputation. People heading key institutions must also believe in their potential to achieve satisfactory standards of conduct (McIntosh, *et al*., 2003; Roubini, 2010). They must also review their attitudes to cope with the requirements and train their associates to adapt to changes and plan for new risks, challenges and opportunities (Moon and Bonny, 2006; Roach, 2009). There should be ample opportunities for companies to avail of proper communication mechanisms, so as to facilitate access to information that would help employees distinguish between acceptable and unacceptable behavior. Transparency must be reinforced and emphasis must be laid on educating people in ethics, so that they know their rights. There is no doubt that a combination of good ethics and proper communication can help organizational members and business partners understand one another's views and respond to corporate and individual needs appropriately. This is the one way to control conflicts of an ethical nature and secure healthy stakeholder relations in a global climate. There needs to be consensus on one point that economies need to be improved on the occasion in executing regulation and supervision as control devices for containing emerging risks (Klitgaard *et al,* 2002, Deviers-Joncour, 2005). Above all, it is only the strength of mind of human being, whoever he or she is, whatever position he or she holds, to inculcate ethics and magnetize others to do the same to make the Universe free from unethical practices and protect it from any further inconvenience.