Unethical dilemmas in derivatives practice

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Abstract

The current global economic crisis and its aftermath resulted of unethical practices of the companies' leaders and their financial management by improper usage or analysis of financial derivative, which turned the financial derivatives into a source of gambling, and spread to extremely large volume. Although, the unethical practices from a financial institution observing lack of ethics is made due to self interest that maximizes immediate profit putting shareholder wealth and small investor at risk rather than maximization of shareholder value.

Unethical Dilemmas in Derivatives Practice

Global financial crisis

The global financial crisis resulted in the threat so severe that some of the world's largest financial institutions have collapsed, the bailout of banks by national governments, and downturned in stock markets around the world. In addition, the global crisis reduced economic growth, increased business risk and influenced equity and credit markets (Xu, 2011). Many economists considered the financial crisis of 2007–2008 as the worst financial crisis since the great depression. However, the global financial crisis caused by improper abuse of three derivative securities of mortgage-backed securities, credit default swap, and collateralized debt obligations (Jo, 2010).

A derivative is a financial vehicle that derives or gets it value from further financial tools (a bond, a currency or a commodity or stock) that known as the underlying instrument (Cutland, 2013). Since the early 90s, the globalization is accelerating. This caused the world economy to serious structural shifts. These issues arise during increasing of competitive pressure. During that period, featured a lot of new financial instruments and the most popular one it is the financial derivatives. However, the most common types of derivatives are as follows:

- **Option**: The purchaser of an Option has rights without any obligations to trade the asset during a given time for a specified price. Forward Contract: is a non-standardized agreement between two parties. However, the both parties obligated to trade a security or any other asset at a specified time in the future.
- **Future contracts:** standardized, transferable, exchange traded contract to sell or buy a standard quantity and quality of an asset or security at a specified time and price.

- **Stripped Mortgage-Backed Securities (CMBS)**: A stripped mortgage spitted into principal-only strips and interest-only strips, which based in cash flow that derives exclusively from interest payments or principal payments on the underlying mortgages (De Rossi, 2010).
- **A Swap**: is the simultaneous buying and selling of the same security or obligation
- **Structured Notes** are mixed combine of debt instruments and derivative elements that include various financial products, which not necessarily reflect the risk of the issuer. "The combination allows parties to confirm, isolate, transfer, and otherwise manipulate risk in clearly defined ways"(Telpner, 2004).
- A **hedge fund** is a peculiar investment instrument target extraordinarily wealthy investors, that promise high rewards. Whoever it may also use leverage, which present a significant risk and the high potential rewards. "Hedge funds employ instruments such as derivatives to gamble with their clients" (Whalen, 2007). In 2010, Allen stated "hedge funds accused of gambling with lives of the poorest as food prices soar".

Unethical Practices

The financial derivatives turned into a source of gambling or risk taking and spread to extremely large volume. According to the bank for international settlements (BIS) "The volume of these derivatives increased by more than three times in the past few years, from less than 100 trillion dollars in 1998 to be greater than 707 trillion dollars in 2011". The growth was not matching by the growth of any sector of the real sectors of the economy. This growth was causing by bookmakers; there 97% of this magnitude was using to this purpose. There is only 3% relating to ordering reduction of risk, and the purpose for which these products are designing. In 2002, Warren Buffett the CEO OF Berkshire Hathaway stated, "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially harmful". In addition, and he stated, "The derivatives genie is now well out of the bottle".

The current global economic crisis, it is a result of unethical practices of the companies' leaders and their financial management "the existing issue came to be the determination of the blameful for disaster and financial managers, which act with their immoderate selfishness, and greediness was suspect of putting the global economic on the brink of an abyss" (Akif, 2011). They did not motivate by ethical considerations. Nevertheless, they appear only in their personal interest and are unaware of how their choices influences upon others. Many unethical issues were arising during this crisis, such as they are putting shareholder wealth and small investor at risk rather than maximization of shareholder value.

The greed and selfishness of the most powerful characteristics of this stage it was observing lack of ethics. In addition, adopted a situational view of morality result of the modern economy, requires that individuals and organizations choose the course of action and engaging in excessively risky behavior that maximizes instant profits, and supports any decision that maximizes individual financial profit (Russell, 2012). When the economies are growth, ethics are seeing as an unimportant issue like luxury goods. However, at times when economic and financial crises happen the ethical issues turn out to be one of the most influential topics at the first item on the agenda (Akif, 2011). In the absence of moral value in a competitive market, or self-interest may cause chaotic and subversive impacts (Homann, 2009, as cited in Saha, 2013).

In 1976, Adam Smith exemplified in his writing the ethical concerns that fairly at variance with finance theory, which rests on a core assumption of profit maximization or the maximization of shareholder value (as cited in Saha, 2013). According to Russell, Dortch, Gordon, and Conrad (2012), the lack of a qualified ethical analysis is the main reasons of financial management mistakes. In addition, the course of action that maximizes immediate gains that shift the managers attention away from Treatment of ethics as case bound, cause the loss of well-established moral character. Nevertheless, it has become a force looking to find its purpose in its self- interest, money generate out money (Pellerin, 2012).

Who Is Responsible

The post global financial crisis has brought up the most ethical question: who is responsible for causing the crisis. Pellerin and Casimiro (2012) argue that a financial crisis caused by the conflicts of interest between shareholders, which present the CEO and mangers interests versus shareholder interests and stockholders' interests versus the interests of company clients. Nevertheless, Heinemann (2011) stated the lack of a qualified ethical analysis is the main reasons of financial management mistakes (Heinemann, 2011). In addition, Kampits (2009) attributed the cause of the crisis to split up the economy from all other areas of life; it becomes possible to notice the sickness reflected in the greediness of managers, speculators, and shareholders. Lewis, Kay, Kelso, and Larson (2010) considered global financial crisis that result of unethical lending systems by main lending institutions, and the lack prudence and pushed ethics aside as greed overcame good judgment among mortgage lenders nationwide. Kuriata (2011) argue that a financial crisis caused by:

The bankers who effectively hand over credit risk to third parties and agree to them to cut down their capital requirements.

- The risk calibrations pay no attention to the systemic risks to which financial organizations exposed.
- The bankers' actions of the market and credit risk were incomplete despite a sign of improvements and toke place state as evidence rather than criticism.

Conclusion

The greed and selfishness of the most powerful characteristics of this stage it was observing lack of ethics. The lack of or absence of ethics and values was at the root of many of the problems facing the global which created the post financial crisis. In addition, amidst a crisis the economists cannot expect the harmful things that can get in today's changeable global economy while there is no exact solution for this dilemmas facing the entire global. However, we should intend at preventing further crises of a social and financial that would require a new mentality change of investor and financial managers. Companies' leaders and financial managers must take a risk responsibly understanding that is a part of a necessary framework for promoting ethics and integrity in finance. Moreover, integrity must be effective in all parts of the institution, with a strong focus on monitoring. In addition, an ethical financial structure is crucial to the healthy functioning of the whole economy. Carry on these changes should be a necessary component of the improving the financial system from this era of excesses. The financial institution attempts to determine what that equilibrium relationship between interest groups conflicting demands. Furthermore, the financial ethics should receive some attention in finance education.

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