Jan Sijbrand: Ethics and the crisis in the financial sector

Speech by Mr Jan Sijbrand, Executive Director of the Netherlands Bank, at the University of Groningen, Groningen, 5 September 2013.

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Dear faculty, students, and staff, let me start by thanking you for the opportunity to speak at this festive opening of the academic year.

When I enrolled at university to study mathematics, it had never crossed my mind that this choice might one day lead to a career in the banking sector. I just liked mathematics, is what I remember. Besides, in those days and in the first ten years or so after my graduation, banks weren't interested in hiring mathematicians.

But as in the following decades banking products grew more complex, banks began to turn their eyes to professionals with my academic specialty.

So this is how, after working with Shell for a number of years, one day I switched to the financial sector, and came to join, first, Rabobank and, later, ABN Amro. And since 2011, I've been an executive director at De Nederlandsche Bank. *Of course, it can be argued whether it was a wise decision for banks to hire mathematicians ;)*

I gave you this brief overview of the jobs I've held so far, not just to show the students among you that your professional life may turn out different from what you had in mind when choosing a particular field of study… but also to show how my career enabled me to experience and compare different organizational cultures.

Most of you will know that, besides being the central bank of the Netherlands, DNB supervises the financial sector. Within the scope of that latter task, I am responsible for what we call the "prudential" supervision of banks, insurers, and pension funds. This means that we at DNB watch over the solidity of financial institutions and the financial stability of the system.

This does not imply that DNB is only interested in "the numbers" – the liquidity and solvency ratios of banks. For "the numbers", are only part of the story when things go wrong. Obviously, other factors that come into play, as the recent crisis in the financial sector has made clear. I am referring to the cases of unethical behavior of bankers that emerged during and in the wake of the crisis. Where and why did things start to go wrong? What are the possible remedies? And what is the role of DNB as prudential supervisor? These are the topics I would like to focus on today.

Let me start by giving an example of unethical behavior of bankers before the crisis. Just some weeks ago, a former Goldman Sachs banker – Fabrice Tourré – was found guilty of fraud by a jury in New York City. Mr Tourré was held responsible for seriously misguiding his clients in the so-called "Abacus deal". Abacus 2007 was the name of an investment in residential mortgagebacked securities, a product that yields income from mortgage payments by homeowners.

The deal was as follows: while Goldman Sachs sold the product, while the intermediary company that arranged the deal, Paulson & Co., went "short" on the deal. That is, they bought other products that would bring in vast amounts of money if these mortgages were to default. To make sure that this setup would work, the mortgages selected for the Abacus investment had a high chance of defaulting.

Of course, the clients to whom Goldman Sachs and Paulson & Co sold this product were kept in the dark about this. In other words, what Tourré and Paulson did was seeking to maximize their profits at the expense of their clients. It is therefore hardly surprising that this scheme, once it transpired, led to a significant loss of trust in the financial sector in general.

This example illustrates how a bank can engage in unethical behaviour by deliberately misguiding its clients, and betting against them. Let us now take a closer look at the banking business in general: where and why could things go wrong the way they did?

A bank is an intermediary between people who have more money than they want to spend, and people who would like to borrow money. Put briefly, a bank's business is to earn money with money. In some cultures and traditions this is considered inherently immoral. In our society, we find this perfectly acceptable, and even consider it indispensable for our economy to function properly. The past few years have clearly shown, however, how things can go amiss.

As the former Chief Economist of the IMF, Raghuram Rajan, put it:

"Because [bankers'] business typically offers few pillars to which they can anchor their morality, their primary compass becomes how much money they can make" (Rajan 2010: 126). The question, then, is "in whose interests are banks working?"

Before, say, the year 2000, banks used to focus on the interests of their clients, their employees, and their shareholders. In other words, they focused on the interests of all of their stakeholders.

But in the early years of the present millennium, their focus came to rest more and more on the interests of shareholders alone. "Managing for value" became the new creed.

As I see it, this approach made for an imbalance in bankers' decision-making. It came to stand in the way of how banks ought to operate, and created problems for all parties involved, bankers themselves included.

Let me explain how "managing for value" led to imbalanced decision-making. "Managing for value" fostered both *short-term* and *instrumental thinking*. Clients became instruments to extract money from in order to maximize profits and thus increase shareholder value. Employees were hired on the basis of their capacity to make as much money as possible and as fast as possible, rather than for their capacity to make a sustainable contribution to the bank.

Bank boards cut staffing, and launched new strategies, sometimes yearly; all in order to gain and hold shareholders' attention; not because it was in the bank's best interest or that of its clients and employees. So, one might say that by focusing on "managing for value" only, banks lost track of what is required to maintain the right balance.

Banks play a crucial role in our economy. A role that goes beyond maximizing profits for their shareholders. Banks are intermediaries: people deposit their savings at a bank, and a bank provides credit to those who need money. This is a bank's chief task, and its main role in our economic system and in our society. It is a bank's *societal responsibility*.

Just like other companies – such as Shell, KPN, and Akzo Nobel – a bank, too, has a specific role to play. A bank should strive to perform this role properly, in a balanced way, in order to hold the trust of its customers and potential customers.

This trust will be eroded if a bank fails to do so and has no mechanisms is place to prevent the excesses we saw in the years before the 2008 crisis. And how serious this loss of trust can be is evident, for to this very day we are still working hard to restore trust in the financial sector.

Let us now turn to the possible remedies for the gap between bankers and the rest of society; the gap that has partially been created by the unethical behavior displayed by some bankers.The first possible remedy is to criticize bankers severely and persistently. This remedy has been applied in recent years, for bankers have been "bashed" quite severely over the past years; in many cases for the right reasons.

But, while some feel this bashing should continue until banks own up to their errors, let's not forget that we cannot do without banks. They provide services that are vital to the functioning of a modern economy.

Also, let us bear in mind that the ongoing criticism may have a negative side-effect. As anthropologist Joris Luyendijk – who observes bankers in London's financial district – points out: instead of subjecting themselves to self-criticism, bankers tend to grow indifferent to the public's view.

Some even go as far as to argue that "clearly we must have done something right, now that so many people seem to be jealous of our success". Rather than changing their ways, bankers tend to wait until the crisis and the criticism have blown over. Perhaps, they hope that once the economy picks up again, everyone will have forgiven and forgotten their errors.

To quote Rajan once more: severely criticizing "the immorality of bankers has made for good rhetoric and politics throughout history, but it is unlikely to address the fundamental reason why they can do so much harm".

So, if bashing is not the solution, how then should we close this "gap" between society and bankers? Surely, a charm offensive by banks wouldn't do the trick. Any such course would be futile, since many people distrust them too deeply for that. And "actions speak louder than words" anyway. I therefore think the best way out for bankers may instead be to quietly and properly do their job, just as society would want them to.

Or should we solve this problem by establishing an "ethics office" at every bank, as is sometimes suggested? Of course, the attention we see these days for ethical dilemmas is laudable. But the risk of having a dedicated ethics office is that the rest of the organization may come to think that they no longer need to worry their heads over ethics. If this should be the effect, an ethics office would even be counterproductive. For instead of making the organization as a whole more ethical, it would prompt a "box-ticking" attitude.

Therefore, rather than focusing on establishing ethics offices as a "second line of defense", we should focus on the ethics of the "first line of defense": the bankers themselves.

Another option would be to impose more rules on the financial sector. Of course, some of the extra regulation that has been introduced was necessary.

For instance, the Basel III rules which provide that capital ratios have to be raised.

Yet, in my opinion, extra rules cannot solve all of our problems. For every new rule will lead to creative solutions to evade that rule. By making new rules, we won't make bankers less greedy, nor will we make them more ethical. Instead of overregulating every detail, we should focus on the decisions bankers make.

This point – how decisions are to be made – deserves to be discussed in greater detail. A bank is governed by a board of directors and by senior management. These officers decide on the bank's strategy and key targets. Their decisions have far-reaching consequences for the bank's operations, as the example of "managing for value" demonstrates: a misguided decision may have undesirable effects.

This considered, I would like to focus on the way bankers should make their decisions. The classical virtue "Prudentia" – in modern English, "Prudence" – can help us here. Prudentia is the virtue that stands for "making careful decisions". It requires a capacity for reflection, careful analysis, and balanced judgment.

This sounds like a goal worth striving for, but what does it mean in banking practice? In banking practice, it means that, instead of focusing on one interest in particular, bankers have to balance all of their stakeholders' interests. They should neither focus on their shareholders alone, nor on a specific category of their clients. Bankers practicing prudence take their societal responsibility to heart, which is: to be a trustworthy intermediary.

Therefore, to be “prudent” decision-makers, bankers should:

- scan which interests are at stake,
- balance the different interests involved,
- reflect on the consequences of their actions,
- and show themselves “moderately risk-prone”.

By making careful and balanced decisions, and reflecting on their societal responsibility, bankers will regain the trust they need to function optimally. What does DNB do as *prudential* supervisor to improve the “prudence” of bankers?

In recent years, we have focused more heavily on good corporate governance, and expanded our supervisory scope to include business models, behavior and culture. By looking closely at business models, we want to increase our understanding of how banks actually make money and become better able to discern high-risk strategies. In our supervision of behavior and culture, we aim to make banks’ senior management more capable and more careful decision-makers.

Let me give you two examples.

First, our “fit and proper” tests for aspiring board members have become more thorough.

We have added requirements such as:

- being sensitive to external developments;
- being able to take balanced decisions;
- and taking responsibility for the outcomes.

We have done so as we want banks to have more competent decision-makers on their boards.

Second, our supervision of governance now also covers board effectiveness. We measure this aspect by observing the behaviour of board members during meetings.

We analyze their performance, and reflect on the way they operate, asking challenging questions like:

- Is the chairman too dominant?
- Is the board really “in control”?
- How does the board communicate? and
- Is there room for differing points of view?
- Through these new developments, we aim to foster *prudent* decision-making and stimulate reflection.

Ladies and gentlemen,

I’m going to summarize the main points of my speech.

I’ve approached the theme of this gathering, “Ethics and the crisis in the financial sector”, from my perspective as executive director responsible for prudential supervision.

I’ve made a case for how banks can restore confidence as an essential building block for a healthy economy. The remedy for the current confidence crisis neither lies in bashing bankers, nor in a charm offensive, nor in establishing ethics offices, nor even in imposing more rules. Bankers need to become prudent decision-makers again. This will restore the balance required for them to function optimally.

This is how I look at the issue. I'm aware that others may hold different views and will be happy to answer questions during the panel session.

Finally, I wish all students and faculty members gathered here good luck in their new academic year and hope to see some of you back at De Nederlandsche Bank one day, when your career takes you where maybe you hadn't expected to go. ;)

Thank you.