

# Andreas Dombret: Why business needs values – what we can learn from the banking sector

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Academie Kloster Eberbach, Eltville am Rhein, 17 November 2017.

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## 1 Introduction

Ladies and gentlemen

It is said that the Viennese writer and journalist Karl Kraus once asked a budding academic what he was planning to study, upon which the young man said, “Business ethics.” To which Kraus replied, “One or the other, you can’t have both.”

This brief exchange rather neatly reflects a view held across much of our society – that business and ethics are irreconcilable rivals at opposite ends of the spectrum. It is widely thought that the banking sector, more than anywhere else, bears testament to this idea of business being an ethics-free zone.

And who could blame them for thinking that way? After all, financial crises and scandals – like the one in which banks colluded for years to rig benchmark rates – don’t exactly put the picture straight. In some instances, these scandals were rooted in unethical behaviour. Court rulings, fines and an exodus of customers are a stiff price to pay for this conduct, not least for the banks themselves.

Every single scandal, every single crisis, adds to the chorus of voices calling for more regulation, more supervision. Could supervisors, they say, not make sure that ethics are anchored once and for all in the business world?

And it’s true that, in some instances, banking supervisors are increasingly encroaching on this ethics debate with some of the steps they take. There are two new ways in which we do this which I would like to discuss in greater detail during the course of my speech.

To make sure we’re not talking at cross purposes, I’d like to take a minute to share with you my understanding of ethics, or values, and ethical behaviour.

For the purposes of this speech, values, for me, are behavioural anchors, or characteristics and qualities that are considered worthwhile and morally sound. Honesty, solidarity and responsibility are just some of the values I could mention that most would regard as worthwhile. My definition of ethical behaviour, meanwhile, is behaviour that embraces those very values.

I would like to spend the next few minutes answering the following questions: Why should banking supervisors be interested in values? Where are banking supervisors promoting ethical behaviour? Can values even be a matter for banking supervisors in the first place, and should they be? At what point do rules and supervision reach their limits? And do we need a code of ethics in the business world?

## 2 What we can learn from the banking sector

Why exactly does business need values? After all, it’s perfectly adequate for the market to be guided by the invisible hand of competition – at least that was the predominant view before the financial crisis struck. There is no lack of controversial views claiming that business and ethics are locked in eternal conflict. US investor George Soros, for instance, once said that the profit-maximising behaviour characteristic “ignores the demands of morality”, thereby rendering

financial markets amoral rather than immoral. Following Mr Soros' line of thinking, then, perhaps we don't actually need any values at all in business? Isn't "competition", in and of itself, enough of a value for business?

But scour the banking sector and you will find instances where ethics sometimes only played second fiddle, paving the way for what was, at times, glaring misconduct.

The financial crisis, which originated in the US real estate markets in 2007, is a lesson that the consequences of pushing for short-term profits can be catastrophic. Bankers who were convinced that their securitisation vehicles had shifted credit risk off their books let their conservative lending standards slip, which meant, in a nutshell, that they ended up issuing and securitising far too many risky loans. In a second step, those bankers underestimated the possibility that those loans might default because of a lack of due care and also the opacity of those securitised products. Compensation models rewarding short-term behaviour did the rest.

This all set a cycle of events in motion in which loans were systematically granted to customers who were unable to service them. Not just that: in some cases, customers were deliberately mis-sold loans, all in the interest of pocketing quick gains. It's hardly surprising, then, that the crash in the US real estate market proved to have very far-reaching implications, not least in the shape of enormous costs for banks and a loss of confidence. The court rulings, fines and customer exodus I mentioned earlier thus continued to take their toll on banks long after the US real estate market went into free-fall.

Bearing all this in mind, one could be forgiven for thinking that it was unethical behaviour which made the financial crisis possible in the first place. Financial mis-selling and a focus on short-term profitability were rewarded, securitisation encouraged opaque and dishonest conduct, and there was no such thing as a realistic assessment of credit risk.

There's another example I could mention to show that the market is incapable of regulating itself and that values, it would appear, still haven't made an appearance in some quarters of the banking industry. I'm talking about the Libor scandal – that is, the rigging of the benchmark London interbank offered rate. Bankers colluded to submit fictitious interest rates so as to falsely inflate or deflate Libor. This rigged rate then fed into financial transactions all around the world; many credit or savings products are geared to the Libor benchmark rate.

So if you ask me whether business needs ethical values, the answer is an unequivocal and resounding yes. And as for the other question I asked just now, my answer would be a definite no. Competition, in and of itself, isn't enough; we need rules to stake out a clear operational framework. Leaving the market to its own devices isn't an option. But the question is whether we can achieve this simply with rules and supervision?

Many a new approach in the world of banking supervision is designed to do just that, but if there's one thing I can tell you already, it is that they will never go far enough. Because when it comes down to it, values are beliefs which each and every one of us needs to anchor in our own behaviour. And that is precisely the problem which I intend to delve into later in my speech to you today.

### **3 New approaches to banking supervision**

Traditional banking supervision aims to maintain checks, create trust, and, ultimately, ensure a stable banking system with solvent institutions. However, some new approaches to banking supervision are going one step further, even if only as a side effect. I would like to introduce two of these measures to you now: first, what is known as salary regulation and, second, the Task Force on Behaviour and Culture.

Salary regulation governs the minimum standards for the remuneration systems of German

financial institutions. During the course of the reforms following the financial crisis, particular attention in this regard was paid to avoiding distorted incentives.

On the one hand, there are “clawbacks”, which allow variable remuneration that has already been paid to be reclaimed in cases of severe personal misconduct. On the other hand, payment of variable remuneration may be postponed; in addition, payment is made partially in stock options. This aims to encourage sustainable decision-making and limit short-term thinking geared only towards profits.

The Task Force on Behaviour and Culture is a project that is still in its test phase. However, the results are of such great interest for our discussion today that I would like to briefly present them to you now. The Task Force is working towards developing a methodology for evaluating behaviour and culture in banks. No need to worry – although it may sound vague, I can assure you that this is certainly not the case.

In specific terms, it intends to assess the work and cooperation of supervisory bodies and management boards. For instance, are banks implementing planned strategic changes effectively? Are there any risk-relevant behavioural patterns in management boards or supervisory bodies? These behavioural patterns can be seen as early warning indicators or even as problem drivers in terms of an institution’s financial return and risk profile.

The results of the first studies in banks show, on the one hand, that risk-relevant behavioural patterns, such as ineffective leadership and group dynamics, are indeed present and, on the other hand, that strategic changes are, to a certain extent, only being implemented ineffectively. There is undoubtedly a lot of catching-up to do.

Both the Task Force on Behaviour and Culture as well as salary regulation therefore seem to promote ethical behaviour, or, more specifically, to punish illegal behaviour – which is often also unethical. Although they do not actively impose values of their own, they punish a lack of values.

These measures highlight one thing very clearly: we, as banking supervisors, firmly believe that business needs values.

Please allow me to now expand upon something that I mentioned earlier: rules alone cannot entrench values in business. There are two reasons for this. First, rules have natural limitations, and, second, values are subjective and must be recognised by each person individually. For now, I would like to delve deeper into the first point – the limits of regulation.

#### **4 The limits of regulation**

There is one thing that we can all agree on: we need an operational framework and ground rules for business. An operational framework creates trust and thereby attracts investors and customers. For this reason, the banks themselves also have an interest in a functional operational framework.

At this point, I would like to explain in greater detail two phenomena that impose limits on regulation: first, the challenges of globalisation and, second, the concept of what is known as homo oeconomicus.

Globalisation presents us with immense challenges that cannot be overcome at the national or European levels in isolation. Global problems such as environmental protection, security, and financial stability require collective solutions and in no way affect just one country or just economic agents alone.

Furthermore, it is not only economic agents who now face global competition, but also the ground rules applicable in each jurisdiction. A regulatory race to the bottom is often the response

to this competition between locations. We are indeed trying to contain this through our work in international committees but, as long as there is no global operational framework in place, an ethical vacuum is created here. Just because something is legal or not yet subject to global sanctions, it does not ultimately mean that we should also behave that way. Legality does not automatically mean legitimacy.

The second phenomenon that imposes limits on regulation is the concept of homo oeconomicus, which forms the foundation of most modern economic models. In short, it describes an ideal person who acts purely rationally and therefore makes the most optimal decisions possible.

However, business consists of an intricate web of agents who are guided by human decisions. Unlike homo oeconomicus, humans are not purely rational beings, so it goes without saying that decisions are often shaped by emotions – and humans are prone to human error. In cases of doubt, ethical vacuums can arise here, too.

Let me summarise so far. First, business needs values. Second, some of the latest tools in banking supervision are moving increasingly in this direction. Third, every operational framework has limitations through which ethical vacuums can arise. Fourth, we cannot comprehensively entrench values in business through regulations, even if this may be possible theoretically. Values must instead be recognised and adopted by each person individually. It is this fourth point that I would like to discuss in more detail.

## **5 Does the answer lie in more supervision?**

One way of responding to the fact that there are limits to what a rulebook can achieve might be to introduce ever more intricate supervision, so as to cover as many scenarios as possible. Ethical vacuums could be plugged with a maximum of rules, each of them as detailed as possible, eliminating the need for the individual to think about what is right or wrong.

And indeed we can do this up to a certain point – salary regulation and the task force which I mentioned earlier are two examples. These new initiatives are increasingly making inroads into the realm of values and morals, serving at least to penalise unethical behaviour.

It is tempting to think that, if new rules make people conform to certain ethical patterns of behaviour, supervision can take care of values. Simple! But it doesn't work like that – and here's why.

Supervision cannot anchor values in the business world. Granted, it does so sometimes “by the by”, as a side effect of penalising conduct which is both illegal and unethical, as with the two examples I've just mentioned. But we do not prescribe values that market participants must abide by.

Rather, our efforts to prevent certain unethical strands of behaviour are based on economic factors. We have neither the ability nor the desire to vet whether somebody alters their behaviour because they either accept and prize values such as honesty and responsibility or fear negative repercussions.

Your instinct may be to think that whether bankers behave in an ethical manner because they believe that it is the right thing to do or just because they feel forced to do so is neither here nor there. The end result is, after all, the same.

But that is far too simplistic; the end result is not the same. On the one hand, we have bankers who believe in values such as honesty and solidarity. They will always behave in an ethical way, even if given the chance to behave unethically without being caught out.

On the other hand, the sole reason that some bankers are not behaving unethically is because they are being held back by the operational framework. They will always seek – and probably often find – a way to behave unethically.

Please don't get me wrong, the majority of people, and the majority of bankers, are honest and their behaviour is value-led. But we are only human, and it is simply human nature to want the best for ourselves and those close to us. Any debate around values will always hit upon this snag.

So, for a variety of reasons, values cannot be embedded in business by regulation alone. First, because globalisation and irrational behaviour limit what rules can achieve. And second, because even if rules were not naturally limited in this way, every individual has to acknowledge and live by values – they are not something that can be forced.

So, if we accept that rules alone are not enough to anchor values in business or the banking sector, how can we embed these standards? I would argue in favour of a code of values.

## **6 Conclusion**

It makes sense for values to have a place in business. Values can prevent unethical behaviour, averting future scandals and crises. In other words, it is not pure idealism which speaks in their favour; values can in fact cut costs.

Banking supervision does what it can within its remit. Salary regulation shows that by imposing rules we can at least give the business world a push in the right direction, helping to embed these values. And the Task Force on Behavior and Culture is another useful addition to the banking supervision toolkit.

But we should be under no illusions. It cannot be the primary task of banking supervision to establish or monitor values in business or, more specifically, the individual. So, how can we establish values in business if an operational framework does not suffice?

I am convinced that the solution is to be found, as is so often the case, somewhere in the middle. We need rules to provide us with a sound operational framework and we also need a code of values to guide us when we encounter an ethical vacuum.

A code of values can help us to make decisions in situations where rules leave open some leeway and where the decision maker is not the homo oeconomicus but a person like you or me. A code of values will hopefully make ethical decisions easier for us.

Values can only be generated through a combination of reflection, dialogue and information. A code of values that we all voluntarily stick to will only endure if we can clearly see that it makes sense.

This, in turn, throws up a whole series of questions.

Who should the code of values apply too? Do we need a general code of values, or ones which are branch-specific? Which values should be written into our code? Do we want enterprises to be accountable? Should we follow the example set by hospitals and expect all major decisions to be brought before an ethics committee?

These are not questions which I can (or wish to) answer alone. Every individual must choose for themselves to be guided by the same code of values. In the same way, the decision as to what that code of values should look like, or whether we want one at all, is one that must be taken collectively.

If we wish to do more than simply pay lip service to the notion of a credible code of values, then

we must make a genuine effort to engage with the issue. Information and transparency, sharing knowledge and discussing ideas – this is how we can bring a code of values into focus. Not least at events such as this.