ETHICS IN FINANCE, FINANCE IN ETHICS

NEW APPROACHES TO FINANCING AND SOLIDARITY

PAOLO GARONNA
FABRIZIO SPAOLONZI (ed.)

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Banche Assicurazioni Finanza
Italian Banking Insurance and Finance Federation

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The relationship between ethics and finance has always been a controversial and complex one. But there has been recently a turning point. In the world of finance, there is a new awareness of the importance of the ethical dimension, and a wave of initiatives to consolidate the ethical foundations of financial activity. In the world of ethics, in turn, attention is growing on the possible role of finance for poverty reduction and the common good. The contributions we have collected in this volume explore some of the changes underway in the relationship between ethics and finance and provide evidence of this new and more constructive interplay.

This volume collects essays by Robert Annibale (Citi Group), Davide Dal Maso (Avanzi), Miguel Poiares Maduro (former Minister for Regional Development, Portugal), Domingo Sugranyes Bickel (Centesimus Annus-Pro Pontifice Foundation) and Paolo Garonna (FeBAF and LUISS Guido Carli University).

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Table of Contents

Preface ....p. 9

Ethics and finance in search of a new relationship
PAOLO GARONNA ....“ 13

1. A long history of mutual hostility ....“ 13
2. The exception of St. Ambrose ....“ 14
3. The “Monti di pietà” and the solidaristic tradition of mutual lending ....“ 15
4. From the moral exception to the double standard..........“ 16
5. The dichotomy between ethics and finance....................“ 17
6. “And Forgive us of our Debts” ....“ 19
7. Insolvency and the ethics of debt...................................“ 21
8. Public deficits: Victorian versus Keynesian ethics...........“ 22
9. Sustainable debts versus excessive debts ....“ 24
10. The austerity controversy in Europe: economic or moral? ....“ 28
11. Beyond good and evil. The role of the State ....“ 30
12. The new ethics of bail-ins ....“ 32
13. A turning point: the Pontificate of Benedict XVI............“ 34
14. The nexus linking knowledge and values.......................“ 37
15. The ethical foundation of finance ....“ 38
16. Ethics and social capital ....“ 40
17. Why banks are special: the treatment of insolvency ....“ 42
18. Banks as liquidity providersy..“ 44

19. The systemic impact of financial activities .... " 46
20. Pervasive moral hazards... " 48
21. Credit creation and leverage.. " 49
22. Redistributive implications:
creditworthiness and meritocracy .... " 53
23. The social role of finance .... " 55
24. Towards the ethical recapitalisation
of the financial industry .... " 57
25. The next stage in the relationship
between ethics and finance .... " 59
26. Leverage for good:
the new frontiers of social investment .... " 59
27. The poison of gifts: limits of the gift economy .... " 62
28. In search of a third way
between private charity and public welfare .... " 64
References .... " 66

Ethics in finance:
the experience of sustainable finance in Italy
DAVIDE DAL MASO .... " 71

Social innovation and impact investment:
redefining the social contract
MIGUEL POIARES MADURO.. " 79

Internally-driven ethical reconstruction: is it happening?
ROBERT A. ANNIBALE .... " 87

1. Beginning at the level of the corporation....................... " 87
2. Meeting regulatory expectations
and external stakeholder engagement........................... " 90
3. Responsible and inclusive finance .... " 92
4. Conclusion.. " 93

Investing in sustainable finance and social infrastructure – Public Private Partnerships
DOMINGO SUGRANYES BICKEL .... " 95

1. New social demands offer great opportunities .... " 96
2. "Help the poor help themselves" .... " 97
3. A role for solidarity in business decisions .... " 98
4. Finance with a purpose .... " 100

Micro- and Macro- approaches to ethical recapitalization of the financial sector
PAOLO GARONNA .... " 101

1. Introduction .... " 101
2. Conceptual foundations: trust, uncertainty and solidarity .... " 103
3. The prevailing uncertainty of the global risk scenario .... " 104
4. Financial development: more solution than cause of the problem .... " 105
5. Build ethics from below: lessons from the corporate sector .... " 106
6. From Micro- to Macro- ethical reconstruction: the question of profitability .... " 107
7. Conclusion: towards a global strategy, Micro- Macro- and Meso- .... " 109
8. Focus on finance for the poor .... " 110

Appendix .... " 112
References .... " 113

List of authors .... " 115

Preface*

Ethics and finance have always been at loggerheads with each other. Since the beginning of history. But there has been recently a turning point. A promising new process of mutual cross-fertilisation appears underway.

In the world of finance, there is a new awareness of the importance of the ethical dimension, and a wave of initiatives to consolidate the ethical foundations of financial activity. In the world of ethics, in turn, attention is growing on the possible role of finance for poverty reduction and the common good.

The contributions we have collected in this volume explore some of the changes underway in the relationship between ethics and finance and provide evidence of this new and more constructive interplay.

> *People's new awareness, raised by social and environmental crises, generates effects in several directions: citizens-voters push their representatives in the political arena to pass more stringent regulations – that, in turn, penalize (or reward) corporates' social or environmental policies; citizens-consumers use their purchasing power (the so-called 'vote with the wallet') and determine the success of companies' business strategies; citizens-employees transfer their values in the organisations they work for, promoting the change from the inside. Like a tide, the new social sensitivity instils the seeds of change at any level.*
> (Davide Dal Maso, *Ethics in finance: the experience of sustainable finance in Italy* in this volume).

* The opinions expressed in this publication are those of the authors, and do not necessarily represent the views of the respective organisations.

The financial sector is at the forefront of this tide of rising social sensitivity. Sustainable and Responsible Investment (SRI), the integration of Environmental, Social and Governance (ESG) factors in investment strategies, are just one example of a shifting paradigm involving the social contract and globalisation. Globalisation, as described in this publication, is perceived as performing a critical function of "*redistributing wealth between different set of actors*" (Miguel Poiares Maduro, *Social innovation and impact investment: redefining the social contract*). In a context where the mobility for capital has become easier, in particular in Europe where an ambitious programme has been launched of Capital Markets Union, many activities in the economy and society have become more closely interconnected. Not only businesses, but also individuals, households, trade, technology. Also the "*technological revolution*" is having a significant and relevant redistributive impact, because the nature of the new products and services that it creates is such that value added is often very strongly concentrated.

In this challenging global scenario, the main role of finance in channelling capital into the real economy and supporting sustainable growth over the medium to long term acquires greater meaning and significance. And, in assessing investment opportunities, it becomes correspondingly more essential to consider a broader range of parameters beyond strictly financial ones.

This is the reason why a *culture of ethics* (see Robert Annibale, *Internally-driven ethical reconstruction: is it happening?*) for financial institution is needed, and has to be developed and fully implemented. Financial institutions play a critical role in society and should be committed to investing in urban infrastructure and economic progress responding to growing people's needs in fields as different as housing, social services, energy, economic empowerment, financial inclusion and physical and intangible infrastructure.

Investors, as written in this book, are facing new challenges and decide asset allocation not only considering the stability and profitability of investees, but also a broader set of dimensions, measured often through a "*set of indicators*" (see Dal Maso) that assess the relationship between management and its key stakeholders, such as shareholders, employees, customers, communities, suppliers, the media, etc.

FeBAF, the Italian Banking Insurance and Finance Federation, is committed to promoting this new vision. In playing its role as a cross-sectoral think tank, capable of bringing together the *Weltanschauung* and the

long-term interests of banks, insurers, asset managers and pension funds, Febaf has placed ethics on the top of its priorities agenda. It engages its associates, national, European and international partners in discussing possible environmental and social consequences of financial sector's developments and strategies. It strives for measures that are key to the creation of a healthier financial environment and a more stable and prosperous economy in the long run.

As a concrete manifestation of its commitment, FeBAF, together with the main Italian representatives of the banking, insurance and financial sector – i.e. the Italian Sustainable Investment Forum, ABI, ANIA and ASSOGESTIONI – promoted the signature of the "*Charter of Sustainable and Responsible Investment for the Italian Finance*". The Charter has highlighted the relevance and the high value that the principles of ethics, sustainability and long term orientation have for the industry. The aim of this "pledge" or agreement is to contribute to a more efficient capital allocation, the achievement of long-term investment objectives, the satisfactory response to citizens' demands and the requirements of medium-long term savings.

In order to succeed in satisfying this new demands, entrepreneurial initiative needs a favourable institutional context in terms of jobs accessibility, education systems, and fiscal-friendly policies to attract investment, stabilise existing ones, and make it possible for innovation and start-ups to grow up and flourish. Beside that, spreading the risk culture and promoting the debate on sustainability and social responsibility amongst the members of the financial and business community is key to maintaining high quality standards for society and individuals.

The private sector, and the partnership between private and public players, play a fundamental role in this challenge. In fact, as underlined in this book, experience shows that

> *Relying on centralized and impersonal public programs does not bring sustainable solutions on either front: qualitative change cannot be achieved through regulation alone; and the old assistance systems can induce a dangerous "welfare trap" based on passivity and inaction which aggravates poverty. Decentralized entrepreneurial initiative is the only context where the new demands can be satisfied.* (Domingo Sugranyes Bickel, *Investing in sustainable finance and social infrastructure – Public Private Partnerships*).

To sum up, finance is today called upon to respond to growing disequilibria uncertainty and instability by identifying measuring and managing risk. This necessitates a particular attention to enhancing knowledge and leadership. And invest in their development. Projects like financial education, financial inclusion and the dissemination of a risk culture have to be carried out and brought to fruition, not only by global players but also from ordinary citizens and private business. It is in this playground that corporate social responsibility, responsible investment, sustainable insurance and social impact investment become new tools for an increasingly competitive market.

> *Competition has stimulated the dissemination of best practise and pushed operators towards investing more and better in business ethics. Branding has come into play as a tool for strengthening the image of social responsibility and the corporate identity of the firm as a caring institution.*
> (Paolo Garonna, *Micro- and Macro- approaches to ethical recapitalization of the financial sector*).

While we are still far from a systematisation of the new approaches, time is ripe for bringing together insights coming from different perspectives and walks of life, developing agreed frameworks for action, and identifying best practise. This is the task of the present publication.

In producing it, we hope we can provide a modest but useful contribution to delivering a global and comprehensive strategy for better ethics and for better finance, capable of gaining the trust of the public and stimulating partnership among the numerous and different players at stake.

We owe it to the professionals working hard in the different sectors of finance. We owe it to the regulators and policy makers facing up to the challenges of a demanding agenda. We owe it to savers and citizens that have to make ends meet in a tight and tense context. Above all we owe it to future generations.

Paolo Garonna and Fabrizio Spaolonzi

Rome, august 2016

Ethics and finance in search of a new relationship

PAOLO GARONNA*

1. A LONG HISTORY OF MUTUAL HOSTILITY

The relationship between ethics and finance has always been a controversial and complex one. The origin of such complexity can be traced back to the beginning of history. For millennia, financiers have been derided, condemned, framed, jailed, and often butchered. Money lending, and money borrowing, appeared to possess an inherently "unnatural" and threatening character that put it in contrast with humanity and social order.

Probably it is the concept of money itself that in a gift dominated economy, and society, generated suspicion and mistrust, as it challenged the conventional sources of authority and public trust (Aristotle). Credit debit and finance predated money and money-denominated assets (Graeber), and were fully integrated *ab initio* in the social order of the various communities. But when they became part of monetary exchanges, markets and trade, they became emblematic of the serious threat posed to sharing, reciprocity, charity, power and culture in human relationships that the new mechanisms implied. The moral challenge then became acute and striking. From the Code of Hammurabi (ca. 1760 BC) onwards, the role of money in society was regulated, formalised and recognised as a necessity, but at the same time, money lending came to be considered immoral and shameful. Lending charging an interest to its beneficiary, called "usury", was condemned, forbidden, sanctioned and punished in various ways. We find this in most religions of the past, from Vedic texts in India to Buddhism and Islam.

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2. THE EXCEPTION OF ST. AMBROSE

In Christianity, a fundamental development took place in the early Middle Ages that was attributed to the responsibility of St. Ambrose, the Bishop of Milan (4th century AD), in his famous book *De Tobia*. Based on an interpretation of the Old Testament, a practise was introduced, and formally incorporated in the *Corpus Juris Canonici*, which would permit interest to be collected in money-lending. "Unto thy brother thou shalt not lend upon usury; but unto a stranger thou mayest lend upon usury" (*Deuteronomy* 23:20). In other terms, lending at interest was permitted if done by Jews in relation to Gentiles, and vice versa. Therefore, the Jews, who had been barred from most professions and from the ownership of land, could legally practise, and specialise, on money lending. Christians and Jews were not morally allowed to lend for money within their own separate communities, as that would be against brotherly relationships. Nevertheless, based on the Biblical predicament, they were legally permitted to trade credit between each other. That practise was often not only tolerated, but actively encouraged, and even placed under papal protection in Medieval Italy. In this way, the expansion of credit, which responded to the growing need and demand for loans required by investment, payments, and naturally wars, became legally possible, and morally tolerable. It was simply the outcome of a "moral exception", and remained therefore consistent with a persisting ethical stigma on finance.

Only much later, in the high Middle Ages and the Renaissance, under the influence of the liberal Popes of the time, often linked to the prosperous and burgeoning Italian republics (.e.g. the Medicis in Florence), moral attitudes evolved significantly. Credit and banking was in the meantime growing fast and supported the expansion of trade, the new explorations and discoveries, the building of modern infrastructures and the magnificent works of art of the time. The concept of "interesse" (from the Latin "intereo", meaning compensation from loss) replaced then that of "usury", suggesting that some form of compensation was legitimate as a kind of repayment for the "losses and damages" that the lender had incurred. Money was not "barren and unproductive" (as in Aristotle), but an essential resource that enabled the creation of prosperity and wellbeing.

3. THE "MONTI DI PIETÀ" AND THE SOLIDARISTIC TRADITION OF MUTUAL LENDING

With the development of agriculture and farming, particularly in Lombardy, the possibility of farmers to lend to one another as a form of mutual help further contributed to build a positive ethics for banking and insurance. "Mounts of piety", called "Lombards" from where they originated, spread all over Europe, and even to-day we find in most European cities "Lombard Streets", named after the pawnshops that once resided there. Christian and cooperative lending took root, buttressed also by a strong altruistic motivation, particularly under the impulse of the Franciscans, but was still fiercely opposed and morally controversial (think of the doctrinal dispute with the Dominicans).

In the Enlightenment, as the European economy continued to grow culminating with the industrial revolution, and banking houses were established to provide credit to a wide array of economic endeavours, the economic understanding of the important productive role of finance continued to improve. But the perception of the morality of lending at interest did not change fundamentally. Enlightenment intellectuals predicated the morality of altruism and self-sacrifice. Usury instead continued to be perceived as a form, perhaps the naked and purest example, of the self-interested blind unfettered pursuit of profit. Therefore morally contemptible and deplorable.

Bentham, and then above all Adam Smith, turned the latter argument, or better the economic rationale of that argument, upside down. Self-interest through the so called "invisible hand" was in their perspective to be seen as a way to increase "social utility". Contractual freedom and the market mechanism could therefore play a useful role also in the field of banking and finance. Bentham in his pamphlet "A defence of usury" even tried to propose a moral justification of credit and lending, based on the notion that innovative trades needed to raise capital, which inherently involved high risk that only the free interplay between borrowers and lenders could assess and manage. But these intuitions remained by-and-large at the stage of theoretical breakthroughs. In practise, Smith's understanding of the operation of credit markets and of the value of money lending made him extremely cautious in his ethical approach to banking. To avoid excesses, abuses and instability, and ensure that individual freedoms actually deliver society's welfare, Smith – and Bentham with him – thought that it was necessary to foresee strong limits and controls

on market players. Utilitarian moral reasoning was highly dependent on the prevailing moral perception of the state of the world, and that perception still considered lending at interest a very dubious practise. Any utilitarian defence of usury therefore ended up logically implying a pervasive Government intervention, limits and constraints, heavy regulation, on a sector considered morally decrepit.

4. FROM THE MORAL EXCEPTION TO THE DOUBLE STANDARD

Following Bentham and Smith, the liberal "Classical" economists of the 19th century (Ricardo, Say and Stuart Mill) and later the Austrian school (Boehm-Bawerk, Menger and von Mises) theorised the importance of lending markets and the social role of freely contracted interest rates, gaining a significant understanding of what was happening in practise. An extraordinary expansion of credit in fact was fuelling the industrial revolution, international trade, the building of infrastructure, the colonisation of the new world, technological development, wide access to home ownership, etc.

It is in this context that the distinction between "interest" and "usury" widened, crystallised and permitted the creation of a kind of double standard. Credit operations were split into two allegedly different concepts: the charging of "interest" and the practise of "usury", leaving it to the public powers to define and regulate such difference. In this way a dichotomy was established between the reality of markets and trade and the ideal configuration of social relationships. This dichotomy managed to maintain the moral stigma associated to lending and at the same time permitted the practical demands of funding and commerce to be satisfied. In one sentence, the dichotomy between the world of ethics and that of finance became established and functional.

In this conceptual framework, regulation took on a social, and ethical, role that went well beyond the need to remedy market imperfections. It performed the critical task of separating what is morally acceptable, and permitted, from what is evil, and condemnable. Obviously, the demarcation lines between the two concepts (usury and credit) have remained fuzzy and often arbitrary, subject to public moods and political manipulation. Keynes felt deeply, and expressed in strong wording, this ethical contradiction we are forced – in his view – to live with, due to the practical requirements of capital accumulation. Thrift, self-interest and precaution are to be considered "moral vices" or – using Keynes' wording

– "the most distasteful of human qualities" that however are an "economic necessity" of the present stage of capitalist development. Let us look at the full quote that I find illuminating of the moral approach of some of the best analysts of modern monetary and credit markets:

> *When the accumulation of wealth is no longer of high social importance, there will be great changes in the code of morals. We shall be able to rid ourselves of many of the pseudo-moral principles which have hag-ridden us for two hundred years, by which we have exalted some of the most distasteful of human qualities into the position of the highest virtues. (…) But beware! The time for all this is not yet. For at least another hundred years, we must pretend to ourselves and to everyone that fair is foul and foul is fair; for foul is useful and fair is not. Avarice and usury and precaution must be our gods for a little longer still. For only they can lead us out of the tunnel of economic necessity into daylight.*

5. THE DICHOTOMY BETWEEN ETHICS AND FINANCE

Keynes' predictions, like those of Karl Marx, did not materialise. In the capitalism of the 21st century, credit and finance have not become less important, nor "less useful". Rather, as we will see later, they are being increasingly perceived as "morally" necessary to build an economy, and a society, more oriented towards the common good. However, this quote shows the widely held ethical dilemma that separates what is necessary from what is good, and the commonly accepted view, dating far back in history, that finance is a "necessary evil" we have to come to terms with. It also shows the supposedly moralising role of regulators and policy-makers vis-à-vis finance: what is not regulated supervised controlled, etc. is *ipso facto* abusive, shadowy, immoral. "Shadow banking" for instance is a good case in point. Punitive regulation and usury laws restricting the rates of interest or constraining other commercial banks' practises have remained in most legislation until recently, and for certain aspects until to-day. In the US for instance State ceilings on interest rates and other norms that fragmented the operation of nation-wide banking and capital markets were wiped out only through the "big bang" of the 1970's and the 1980's. But the dichotomy between ethics and finance, which – as we have seen – had gradually replaced the "moral exception" of the high Middle Ages, has remained alive and kicking, deeply entrenched in the un-

derlying philosophy and the "material constitution" of modern-day financial markets and institutions.

This dichotomy has a profound influence on the public opinion and the political debate. It affects the reputation and the credibility of market players and institutions. It suffices to mention the frequent attacks in political campaigns and in the press against the reckless immorality of bankers, and of European institutions protecting them (the "Europe of bankers"). Actually, for unscrupulous politicians in search of easy popularity attacking banks and bankers has always been an infallible expedient. Bankers are easy scapegoats of crises and economic misfortunes. The pendulum of regulation and over-regulation cycles reflects this moral dichotomy, more than the cycles of instability and business expectations.

The segregation of finance from ethics may have also had some spurious benefits for bankers… if I may use some irony! Left with few ethical guideposts, in a limbo of bad reputation and unscrupulousness, the financial sector has been an easy target to infiltrate for crooks and villains of different kinds. "Condemned to be rich…" said Ferdinand Braudel of the segregated money lenders of the Middle Ages. "Condemned to be immoral…" we might say of the financiers of modern times. In turn, it is undeniable that misfits and malpractices, and correspondingly the various scandals that have plagued the world of finance, have greatly reinforced the segregation of finance from ethics, and increased the distance between the twos. However, the real and primary victim of this dichotomy is the financial sector itself and all its stakeholders, starting from the savers, the investors and the ordinary citizens that rely on it. Overburdened by stifling regulation and ever tighter supervision, sometimes overtaxed, exposed to shifts of confidence and volatility of expectations, faced with increasing demands and risks, banks find it increasingly difficult to-day to cater satisfactorily for the needs of their clients and shareholders. At the same time, they have to remain profitable, compete in cross-border and cross sectoral markets, invest in technology and human capital, engage in sustainability and the future. I am convinced that bridging the gap between ethics and finance would serve above all the interests of the weaker segments of the economy and society, the young, the excluded, those without money and power, those vulnerable people who need funding most and pose also most risks to lenders.

Lending at "interest" came to designate lower premium, lower risk (…) lending, while "usury" came to mean specifically higher pre-

mium, higher risk (...) lending. This artificial division enabled the wealthier, more powerful, more influential people to freely engage in money lending with the one hand, while continuing to condemn the practise with the other. Loans made to lower risk, higher income borrowers would be treated as morally acceptable, while those made to higher risk, lower income borrowers would remain morally contemptible.
(Yaron Brook, *The Morality of Money Lending: a Short History*).

6. "And forgive us of our debts"

The ethics of lending corresponds closely to that of borrowing. If lending has always been considered dodgy from the moral point of view, borrowing has also been tainted with ethical reproach and stigma. It is well known that in German the word for "debt" (Schuld) is the same as for "guilt". To get into debt one must have done something ethically wrong. But the equation "debt equals sin" is etymologically common to many languages, including Greek and Hebrew. In the Lord's Prayer this equation is evoked, even though the emphasis there is not on punishment, but instead on forgiveness:

And Forgive us of our Debts as we also have Forgiven our Debtors

The Gospel's prayer represents a vivid and authoritative reminder of two important aspects of the ethics of debt. 1. The debt contract is considered fundamental, and has been considered as such, in all communities and cultures, and therefore if there is no repayment of debt and that contract is broken, the social order is negatively affected (the concept of debt as sin and guilt); 2. The treatment of people who have become insolvent is central in an ethical approach to debt (Forgiveness). On this second aspect, in the passage from Classical Antiquity to Christianity there was a significant evolution and a break with the cruel and pitiless practises of the old time. Debt slavery, bondage, corporal punishment and debtors' prison, against which already Solon in the Athenian democracy had protested, have remained in use for a long time, even until late in the 19th century, and beyond. The Roman Law notion "fallitus ergo fraudator" (all insolvents are swindlers) implied dealing with the debtor in harsh, often inhuman terms. Debtors' prison were not only a deterrent and a punishment, but were intended also to force debtors (considered fraudsters) to reveal possibly hidden sources.

A more human, and Christian, approach predicated instead debt forgiveness, on a regular basis, as in the Jubilees of the Biblical tradition. We should give insolvent debtors another chance. We should consider the need of safeguarding the positive outcomes of what failed entrepreneurs have achieved, learning from failures and mistakes. The two different moral approaches clashed and co-existed for centuries, and may be seen at play even now in the tensions and debates on bankruptcy reforms.

Bankruptcy systems in fact have been gradually emerging starting from the period of the prosperous Italian Medieval republics (the etymology comes from the Italian "banca rotta", broken bench). The emergence and spread of joint stock companies, and the growing awareness of business cycles and macroeconomic instability depersonalised the reasons for insolvency, leaving fraud as only one among many possible situations of insolvency. Later the recognition of the disruptive nature of innovation and technological change, and the role of "creative destruction" (Schumpeter) in the economics of competition and development further contributed to a fundamental change in the approach to failure and debt.

Finance also contributed to this change of perspective. The modern approach to credit, and debit, establishes a link between risk and yield, risk management and profitability. Therefore, the repayment of a debt should be seen not as a moral (and absolute) obligation, but as a risk-weighted outcome to be assessed in an asset management framework. Increasingly bankruptcies were seen as an economic rather than a moral failure.

> *The nineteen century was according to Mann (2002) characterised by a "redefinition of insolvency from sin to risk, from moral failure to economic failure.*
> (Gratzer and Stiefel 2008, p. 8).

Bankruptcy systems were the outcome of a gradual "moral revolution" or evolution that has fundamentally changed how we deal with debtors and insolvencies. They are nowadays an integral part of the legislative framework required for a well-functioning market economy. Without dealing effectively, and fairly, with insolvencies, in fact, there would be serious obstacles to innovation, competition and economic development. The market economy requires "enterprise demography", i.e. the entrance of new firms and the liquidation of the unsound unviable ones. Without such a system, the economic dynamics would be impaired and there would

be no way to ascertain what is viable from what it is not, what works or does not work. Ultimately, it is the market that "decides" on success and failure, but that decision requires smooth mechanisms for managing inflows and outflows.

The main purpose of insolvency regimes is three-fold. First, to establish equal conditions among creditors in their execution claims. Second, to make arrangements ensuring the continued existence of viable production units in crisis. Third, to find acceptable compromises between the contradictory motives and goals of creditors and debtors. Traditionally legislation has assumed a significant creditor-bias, reflecting the old ethics of insolvency, and focusing mainly on executive procedures and creditors' equality. This view has long been predominant in Europe. More recently, particularly in relation to the attempt at creating a harmonised insolvency framework in the EU, the model of the American Bankruptcy Code has attracted attention with its pro-debtor bias. This model increases the incentives of debtors to return with a "fresh start" after bankruptcy, and creates positive spillover effects on tax receipts, employment and regional industries. It appears more in line with the new ethics of insolvency. However, the creditors' reasons cannot be ignored. "Moral hazard" implications and the risk of "convenience bankruptcies" that undermine the unprivileged claims of subcontractors or taxpayers must be dealt with. This is the case of the so-called "strategic bankruptcies" under Chapter 11 in the US.

7. INSOLVENCY AND THE ETHICS OF DEBT

From the side of borrowing, as we have seen, the ethical focus has shifted from debt to insolvency, i.e. to the repayment of debt. Once incurred, debts will have to be paid. Ethical considerations stimulated the emergence and progress of insolvency legal frameworks that regulate the repayment of debt. They are based on the rule of law and a set of principles and measures that strike a delicate balance between conflicting interests and preoccupations: those of the debtors and of the creditors, deterrence and rehabilitation, moral hazard and forgiveness etc.

But how about debt itself? Is it always and necessarily a "sin"? We might repeat here the considerations mentioned above in relation to credit and moneylending, since the two phenomena are simply the two sides of the same coin. But it is remarkable that while attention on the morality of credit and the provision of credit has always been considerable, relatively little we find on the ethics of debt and on the side of liabilities.

> *The rich rules over the poor. And the borrower becomes the lender's slave.*
> (*Proverbs* 22:7).
>
> *Owe nothing to anyone except to love one another; for he who loves his neighbour has fulfilled the law.*
> (*Romans* 13:8).

On a cursory view, we may find here at play the same dichotomy that characterized the ethics of lending, which is not surprising since the two are specular phenomena. Debt is a necessity of life. It is useful from the economic and social point of view. Debt is needed to invest in a long-term perspective, to face up to shortfalls of income and wealth, to weather the difficulties of life, to support aggregate demand and economic growth (Keynes). But… by-and-large "it is not a good thing". It reflects lack of foresight and prudent management, it creates dependency, it encourages short-termism and adventurism ("in the long run we are all dead" Keynes), it shows a low sense of responsibility, it runs against prudent risk-taking and thrift, etc. In other terms, as it was the case for lending, debt is a "necessary evil". It lives, and prospers, outside the realm of ethics, in a moral limbo ruled by economic and practical mundane preoccupations. The world of debt, as that of finance, is not on speaking terms with the world of ethics. The two cohabitate, but cannot be ethically married.

As with the twin concepts of "interest" and "usury", also on the liability side, a distinction was introduced with practical preoccupations but also ethical underpinnings: the distinction between "sustainable debt" and "excessive debt". But the dividing line between the twos was left rather ambiguous and arbitrary.

8. PUBLIC DEFICITS: VICTORIAN VERSUS KEYNESIAN ETHICS

Economic analysis has tried to fill the moral vacuum of debt and deficit problems. The main author that comes to mind is Nobel prize winner James Buchanan, the founder of public choice and constitutional economics that aim at describing public policies devoid of all normative characters, wert-frei (value-free), or in Buchanan's terms "politics without romance". In his seminal paper on "The Ethics of Debt Default (1987)", Buchanan reaches the conclusion that "a collective decision to repudiate the debt need not, in itself, pull down the whole legal-political house

of cards". Coming from a positivist and a contractarian individualist, such statements appear clearly predictable. However, Buchanan continues "especially if it is accompanied by a change in the rules designed to insure against recurrence of the necessity for repudiation". This latter statement hints at the suggestive moral insights and implications underlying Buchanan's use of the theoretical toolbox of positive economics. His work can be interpreted (see for instance Alvey 2011) as addressed at showing why the Victorian ethical norms opposing public deficits had collapsed under the attack of Keynesian economics, and advocating in their place new legislation, in particular a constitutional norm on balanced budgets. The public choice framework plaid an essential role in Buchanan's critique of Keynes. It showed in fact how, inevitably, relaxing the ethics of fiscal discipline, as Keynes did in his plea for anti-cyclical deficit spending, had led to growing debts and deficits. Democratic politicians are in fact inherently biased towards public deficits, the "fiscal illusion" leads people to prefer debt to taxation, and future rather than current taxpayers end up bearing the burden of today's public debt. Debt is "equivalent to 'eating up' of capital". It has a negative effect on capital accumulation and on the net wealth of society. The Keynesian "moral" revolution – in his view – by undermining the ethics of responsible politics (the Victorian age stigma of public debt) had created a breach in the social capital of the nation, and consequently a permanent loss of productive potential. This needed to be remedied by a kind of "moral counter-revolution". In his approach, this amounted to point out as a solution to the need to introduce constitutional norms, rather than social norms. Such norms would play an ethical role, constraining the free mechanisms of democratic politics and containing the risks of populism.

"*The Victorians had it right*" he added, referring to what he called the "*Victorian fiscal religion*". It is "*grossly immoral to finance current public outlays on consumption, including transfer payments, by an issue of debt*". It is also immoral for one generation to burden another for its own benefit.

> *It is almost impossible to construct a contractual calculus, in which representatives of separate generations would agree to allow majorities in a single generation to finance currently enjoyed public consumption through the issue of public debt that insures (…) utility losses on later generations of taxpayers.*
> (*ibidem*).

Public-debt financing also runs against the American Constitutional principle of "no taxation without representation", because future generations do not vote.

It is somewhat paradoxical that Buchanan, the champion of positive, value-free economics attributes such an importance to ethical issues, and does so drawing basically on his purely rational, engineering and positivistic framework. His criticism of the current state of economic analysis appears therefore particularly credible and biting:

> *Economists have almost totally neglected moral or ethical elements of the behaviour that has generated the observed modern regime of continuing and accelerating budget deficits. To the extent that moral principles affect choice constraints, such neglect is inexcusable.*
> (J. Buchanan, 1985, 1).

9. SUSTAINABLE DEBTS VERSUS EXCESSIVE DEBTS

In the last two decades, the question of sovereign debt has become object of a heated policy debate. Recurrent sovereign defaults and financial crises have occurred in this period determining severe spillover effects on the global economy. That is why the issue has attracted a growing attention at the international level, particularly at the Bretton Woods institutions. But Governments have approached it generally with reticence and embarrassment, for the obvious repercussions that this question has on the concept itself of sovereignty and its prerogatives.

There have been various attempts at discussing and establishing commonly agreed principles, or even rules of the game, on sovereign debt restructuring, particularly at the IMF. These principles would be highly beneficial to anchor market expectations and provide forward guidance on policy behaviour. But these attempts have not been so far very successful, due to the clear preference of the leading countries to deal with sovereign crises ex-post-factum, on a case-by-case and ad-hoc basis. Political and power relationships become then the decisive factor. Such an approach looks fully in line with the dichotomy we have been talking about in this essay. Sovereign debts and deficits belong to the realm of politics, not ethics – it is alleged. It is then up to a political decision and an intergovernmental agreement to determine when and how to rescue a government in financial distress, and under what terms of conditionality.

Thus, Mexico, Argentina, Russia and South East Asia were all considered special and different cases, and were dealt with differently. Obviously, this approach has created diffidence and suspicion. It has pushed several countries (e.g. China) to accumulate on a precautionary basis a huge – and distortionary – amount of international reserves. And it has sometimes fed international controversies. The IMF for instance was criticised in the early 2010's for its treatment of the Greek crisis and the latitude it applied – under the pressure of European Governments – in the evaluation of the sustainability of the Greek public debt.

Economic analysis, notably at the IMF and in other international financial institutions, has tried to build frameworks that could lead to the definition of objective standards in public finance, orientating market reactions and promoting good fiscal performance. The papers by Reinhart and Rogoff is a good case in point, not only for the interesting analytical insights it provided, but also for the reactions and comments it provoked. First, Reinhart and Rogoff published a book in 2009 with an evocative title: *This time is different. Eight centuries of financial folly*. In a fascinating panoramic analysis of the history of financial crises, they aimed at showing that the "this time is different" syndrome is ill founded. Serial default represent a nearly universal phenomenon, a "rite of passage through history", as countries struggle to evolve from emerging markets to advanced economies. Creditors, investors and governments have a tendency not to learn from their past mistakes and indulge into an illusion that each case and time is different from the other, and therefore should be treated differently. Hence, the recurrent comment: "This time is different!". But this is not the case. Episodes of default and financial crisis have taken place in virtually all countries, specifically in emerging market economies as they entered their next stage of development. This has been almost universally true. This observation should suffice to do justice to the commonly held argument, and practise, that sovereign debt titles are risk free and should be evaluated as such in the balance sheets of financial intermediaries for examples. They also highlight some general features that seem to emerge from this overview. They show for instance that debt crises have often radiated from the centre through commodity prices, capital flows, interest rates, and shocks to investor confidence. I believe that the authors overlook the fact the often Governments have a vested interest in adopting a case-by-case approach. Any regular feature or causal pattern in fact could give rise to rules or standards that would tie governments' hands and limit their individual or collective "flexibi-

lity", including the possibility of ad-hoc arbitrary or opportunistic decisions (Buchanan would have subscribed to this line of reasoning).

In a later, and related, paper, published in 2010, Reinhart and Rogoff argued on the basis of an econometric exercise that when "gross external debt reaches 60 percent of GDP", a country's annual growth rate declines by 2 percent, and that for levels of external debt in excess of 90 percent, "GDP growth would be roughly cut in half". Appearing in the aftermath of the financial crisis of 2007-2009, the paper *Growth in a time of Debt* exerted a profound political influence. It was in fact interpreted to provide the analytical, and even quantitative basis, for fiscal consolidation and so called "austerity" policies. They pointed to excessive debt as the main source of financial crisis and stagnation, and were able to define precisely what is "excessive debt". By difference, their analysis enabled to establish an objective distinction between what should be considered destabilising debt and on the other hand pro-growth debt. A neat and practical distinction between excessive and sustainable debt, in one sentence between "good" and "bad" debt.

However, for this same reason, the paper stirred a lot of controversy. It was attacked in academia for methodological flaws. In April 2013 Herndon Ash and Pollin in their paper *Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff* used the same database, corrected for the claimed errors and found that "average GDP growth at public debt/GDP ratios over 90 percent is not dramatically different than when debt/GDP ratios are lower". They accused Reinhart and Rogoff of sloppiness, data manipulation and prejudice.

> *What the Reinhart-Rogoff affairs shows is the extent to which austerity has been sold on false pretences. For three years, the turn to austerity has been presented not as a choice but a necessity. Economic research, austerity advocates insisted, showed that terrible things happen once debt exceeds 90 percent of GDP. But "economic research" showed no such thing: a couple of economists made that assertion, while many others disagreed. Policy makers abandoned the unemployed and turned to austerity because they wanted to, not because they had to.*
> (Krugman 2013).

The technical discussion on the economic impact of debt still rages on, because other studies, particularly at the IMF and the OECD showed si-

milar results to Reinhart-Rogoff, while others disputed or qualified these results. Others questioned the direction of causation: from slow growth to high debt, rather than vice versa. In addition, the estimation of fiscal multipliers by policy analysts has been criticized (Blanchard); often they have been underestimated determining as a consequence of austerity a much heavier fall in economic growth than expected. The jury is still out on the scientific and economic analysis of the relationship between debt, economic growth, employment and financial crisis. Much more work needs to be done to analyse the dynamic factors at play and provide support to an informed policy debate on the most appropriate fiscal policy response to the crisis.

However, soon the discussion has turned away from the economic aspects, and has moved on deeply into political and ideological territory. It has become a discussion on the merits and demerits of austerity policies, with emotional and ethical undertones. What is at stake here is the possibility of establishing an analytical and objective foundation to the definition of debt sustainability, and consequently constraining the Government ability to run its fiscal policy as it pleases. On the whole the preferred and prevailing view on this point is that sustainable debt, which means "good debt", can only be decided by politics, by the agreement of the international community through its intergovernmental fora (the IMF), by their willingness to make available the required resources to support countries under stress. Financial markets incorporate the political dimension of debt sustainability in their assessments and benchmarks. Therefore, they are extremely sensitive to countries' agreements and disagreements, and to political risk scenarios that may influence it.

To conclude, the normative aspects of debt, or debt sustainability, are ultimately decided upon outside the realm of ethics and the normative sphere. It is a situation similar to the one we described in the case of credit and lending. The world of debt operates outside the ethical perimeter. It is left to pure considerations of political institutional and power relations. However, in these relations, thanks to democracy, public opinion, the moods of the electorate or sometimes populist demagogy, ethics resurfaces and indirectly it conditions through the political narrative, or its influence on economic analysis, the debates and deliberations on public debt and public finance.

10. THE AUSTERITY CONTROVERSY IN EUROPE: ECONOMIC OR MORAL?

The discussions on austerity policies in Europe are an even clearer illustration of what it means to separate ethics and debt, the normative and the ethical spheres. As we said, at the global level, it is ultimately up to national Governments, both individually and collectively, to define the normative aspects of debt, what is "sustainable" and can be sustained, and what is to be considered "excessive", and therefore has to be sanctioned. Ethics and debt follow parallel tracks.

But the European Union is different from a national Government. Many people say that it is quite an imperfect and incomplete political construction in comparison to the prevailing model of States and national Governments. I prefer to say it is an original unprecedented architecture that is still searching for a workable equilibrium both internally and in external relations. Whatever we may think of it, the EU, unlike national Governments and political Unions, find constraints in sharing and transferring risks and resources, does not take easily centralised decisions and proceeds mainly through harmonised or uniform sets of rules and normative frameworks. This is particularly so in the field of fiscal policy. The Fiscal Compact, which in response to the crisis has been tightened, recalibrated, proceduralised, but also made more flexible, aims at reducing the risks of fiscal indiscipline, prevent excessive debts and deficits, minimise transfers and rescue operations. The outcome of this construction is that fiscal sovereignty of member states in the EU is fundamentally constrained, subject to quantitative targets (the Maastricht criteria), authorizations, recommendations, sanctions, etc. National Governments cannot do as much debt and deficit as they would like, or need, or are allowed to do by their creditors. Hence, it is obvious that EU intergovernmental discussions over rules, flexibility, application of the rules, etc. are very frequent and heated. Fiscal norms therefore have acquired in the EU context an importance that they do not have in other fora.

National politicians fight to preserve the maximum of their prerogatives, try to shake off regulatory constraints, invoke "flexibility", portray the rules as blind and "stupid", and the European institutions as "bureaucrats" unaccountable to national electorates. European institutions that have the role of normative watchdogs of fiscal discipline, lack "moral" authority and political support, and therefore act often indeed as bureaucrats, finding low level compromises, making the processes painstakingly slow and cumbersome, becoming the scapegoats of all that does not work.

Where is ethics in all that? Nowhere! National Governments and politicians feel unbound by moral constraints in the amount of deficit and debt they can make. National electorates prefer debt to tax rises or expenditure cuts. Brussel bureaucrats arbitrate between debtors and creditors, and stick to the agreed rules. Ethics ends up being whatever it works. And markets speculate on whether it will continue working, or it will fall apart.

But this is only the surface of the problem. In reality, ethical considerations dominate the political discussion over austerity policies. Repressed ethics find its way back, sublimated in the popular narratives over debt and deficit. In the peripheral countries, burdened by public deficits or debt, there is a widespread resentment over Northern European egoism, lack of solidarity, obsession with rules that condemn Europe to grow less than needed, with negative implications for employment and living standards. Debt is perceived as a "good thing", because it enables to finance consumption and investment (the Keynesian argument). And with growth, debt itself becomes sustainable. Austerity policies are seen as cruel, deflationary and often ineffective. They in fact depress growth and hit jobs, penalise the most vulnerable, and even make debts less sustainable.

Northern European people on the contrary feel austerity and fiscal discipline are a necessary medicine for the economy to grow on a more sustainable basis. They are not prepared to sacrifice and pay for the fiscal profligacy of debt-ridden countries. They condemn living beyond one's means that they consider the root cause of debt. They worry that in case of default or financial crisis – induced by excessive debts – they would have to pay more taxes in the future. People feel that Governments unconstrained by austerity would postpone indefinitely necessary and painful reforms (moral hazard), leaving to them the burden of paying for the consequences, in terms of a less efficient European economy and fiscal transfers.

Politicians in general do not feel the moral responsibility of reconciling these different, and both to some extent legitimate, moral pressures. They do not exert moral authority, neither promote they a shared view of the necessary compromises. Often unscrupulous and populist demagogues foment the opposite camps feeding prejudice, disinformation and false expectations. Bad leaders look for scapegoats to their inability to carry on the required reforms, and get support for it.

Why this happens? Buchanan had clearly foreseen this stalemate, and explained lucidly the perverse incentive-disincentives mechanisms at play.

Without addressing explicitly the moral aspects of debt and austerity, it would be impossible to find suitable solutions. Actually, the European experience has shown that also the Buchanan approach to reform, in terms of constitutional limits or norms imposing a balanced budget, does not work. The rules of the Fiscal Compact have to be grounded on convincing ethical bases. Replacing ethical norms with constitutional prescriptions proved to be ineffective. Legal prescriptions can only work if they have a credible and widely accepted moral underpinning. The economics of austerity cannot work if the ethics of austerity is not upheld and supported. The two cannot be replacements for one another.

11. BEYOND GOOD AND EVIL. THE ROLE OF THE STATE

The austerity controversy shows that ethics and debt cannot follow parallel tracks. They have to meet, and rest on joint solid foundations. In the European experience the normative framework is set on an a-priori basis, is applied independently of individual Governments, and it should be binding for them. It looks therefore much closer to a set of ethical norms than the case-by-case approach and the non-binding character of any intergovernmental G20 or IMF framework.

The position of national Governments in the relationship between debt and ethics seems to have evolved significantly in Europe. Conventionally, because of its sovereign prerogatives, the State has considered itself e *legibus solutus*, a kind of Nietzschian Super-man beyond good and evil. Or better, a "poker giver", as it is the State that fixes the norms regulating credit and debit. And in liberal democracies it does so in a secular perspective, i.e. without reference to specific ethical systems. However, in Europe the State Super-man has been losing ground in the fiscal arena. The Government has to accept pre-determined rules of the game and abide to criteria that constrain its freedom of manoeuvre, its "independence".

We find a confirmation of this evolution in the case of the European Banking Union, which was established for the Euro-zone after the sovereign debt crisis of 2011 and 2012. The Banking Union aims at breaking the vicious circle linking financial crises with sovereign debt crises and making the two systemically interdependent. This vicious circle proved all its damaging strength and pervasiveness in the last crisis. That experience had shown that a sovereign debt crisis has immediate spillover effects on the financial system creating stress in the solvency of banks, and that vice versa banking crises affect the fiscal situation of the coun-

tries concerned undermining their public finances. The solution was found in establishing a Banking Union, i.e. an institutional framework through which banks in the Euro-zone are to be separated from their respective Governments, insulating both of them from reciprocal contagion and instability. Banking Union requires a single supervisor at the level of the ECB, independent of national governments. It requires also a Europe-wide regime of bank resolution, so that in case of difficulty banks are not supported or "saved" by "their" Government, but by a European mechanism. Finally, it requires a common framework for deposit guarantee schemes, so that depositors are protected independently of national Governments. This institutional architecture implies fiscal backstops to be set up at the European level, a Resolution Fund capable of intervening in all Euro-zone countries, and a single deposit insurance system to assist depositors. It has to be noted that the latter new instruments, which are not yet operational and still stir heated controversy, represent a significant step forwards in the Euro-zone towards risk sharing and a Fiscal Union, i.e. a common public budget for the Eurozone operated outside the control of national Governments.

Once this overall new construction is completed and becomes fully operational (it might take still some time, and much discussion), all connections between banks and national Governments are expected to be cut. All banks will operate then and be managed within a framework of supra-national European institutions. All banks will be "truly" European. As we said, the European level of governance has a peculiar nature, partly because it is still work in progress, partly because it does not fit the model of a new Nation State or Super state. This implies that the European regulatory framework is special and diverges significantly from other national banking system. In particular, the fiscal backstops in the Eurozone are constrained to be minimal, which implies that asset holders and creditors will have to take on an important part of the default risk in case of insolvency. Banks therefore according to the new Banking Union regime will not be "bailed out" or "saved" by national Governments. But they will not be bailed out either by European mechanisms. They will instead be "bailed in“. The burden of adjustment therefore in case of resolution will not fall only on taxpayers, but will be shared with shareholders, junior bondholders and even big depositors.

The advantage of introducing the bail-in regime in the Eurozone is twofold:

1. it limits the amount of risk sharing among national budgets through the common backstops, and avoids the "transfer union" that arouses so many moral objections in northern Europe; and
2. it minimises the amount of bail-out, and therefore its undesirable consequences in terms of moral hazard and "too-big-to-fail" distorted incentives.

The "bail-in" is a revolutionary concept that has limited precedents and scant correspondence in other banking systems (in the US for instance). It signals a fundamental shift in the priorities of public policy, from the protection of savings to that of the taxpayers. Conceptually, it amounts to a kind of controlled and regulated partial default mechanism. It in fact penalises creditors. Taxpayers should therefore support it. However, naturally it is strongly disliked by bank managers, as it hits share – and bond – holders and even depositors, and it might therefore determine negative repercussions on the stock market, the competitive position of the bank, and possibly spillover effects on public confidence and savings behaviour.

12. THE NEW ETHICS OF BAIL-INS

The introduction of bail-ins marks a significant shift in the ethics of debt.

First, recognition is given to the public-choice moral-hazard argument that excessive debt accumulation should not be encouraged. Hence, severe limits to bail-outs, even when banks, and with them financial stability, are at stake.

Second, it is consistent however with the conventional view that public intervention is necessary (fiscal backstops) to safeguard savings, but limited to low yield and risk free deposits. Systemic crises should be prevented, and public confidence in banks should be maintained. A stable prosperous competent banking system is to be considered part of the social capital of a nation.

The third and most interesting aspect of the ethical shift concerns Governments. With the bail-in principle, national Governments should not interfere with banks and banking crises. The public good aspects of banking and finance should be dealt with independently of Governments. This requires implementing a set of rules, defined on an a-priory basis. And these rules should be widely held as just and fair. Rules then come before and stand above national Governments.

Bail in however requires also the establishment of a light supra-national Governmental stance, where risks resources and sovereignties of the national players can be shared. We see here at play an important shift in the relationship between ethics and the Government. The latter is not anymore the (primary) source of ethics (ethical State), nor is she totally independent of ethics (secular State). But the Government is subject, like any other organisation and any ordinary citizen, to ethical principles, and is committed to uphold them (subsidiarity).

This new approach therefore can be interpreted in my view to mark the end of the ethical exception for Governments in Europe. And it should open the way to treating Governments, and Government debts in particular, like any other organisation – big and small firms, big and small banks, etc. –, any citizen, and any debt.

Bail-ins were invented and gradually introduced to address the issue of "too-big-to-fail", i.e. the fact that the size of an institution can be so big that its collapse would have "systemic" repercussions on whole economies and societies. The financial crisis of 2007-2009 had clearly shown how the links of interdependence applied to financial institutions could ultimately undermine financial stability and growth at the global level. It showed also how the awareness of the power of such systemic links could lead to perverse incentives, rewarding unscrupulous behaviour and encouraging reckless risk taking. The crisis pointed out that fraud and abuses had a basis in the "moral hazard" implications of too big to fail. The "immorality" of moral hazard rested on a flaw of the market mechanism that had to be corrected. The bail-in regime does exactly that, i.e. it defines a set of rules designed to give more responsibility to financial institutions and markets in order to put limits to the immorality of moral hazard.

The new ethics of bail-ins is having profound and wide-ranging implications. It has paved the way to establish rules for sovereign debt restructuring, as in the case of Greece, and the European Stability mechanism. It has implications for the prudential treatment and evaluation of sovereign debt at the Basel Committee or the introduction of limits to the holding of such debt by financial intermediaries in the Euro-zone. I believe it is an ethical break-through, and it is not surprising therefore that it still arouses intense opposition, deep doubts and sometimes visceral reactions.

The logic of bail-in can be applied also to governments. Governments should not be, and should not consider themselves to be, "too-big-to-fail".

Above all, sovereign debt, like any other debt, should be governed by a set of agreed principles, that strike a reasonable balance between the different interests at stake, and that are perceived by the players as fair and effective. In other terms, it should be dealt with in the framework of a rule based multilateral international mechanism. A precedent in that direction is the Heavily Indebted Poor Countries Initiative (HIPC). Following extensive lobbying by NGOs and other bodies, the IMF and the World Bank launched this initiative, which provides debt relief and low-interest loans to cancel or reduce external debt repayment to "sustainable" level. Assistance is conditional on the national governments of these countries (39 poor least developed countries, of which 33 in Sub-Saharan Africa) meeting a range of performance and economic management targets and undertaking economic and social reforms. The initiative has been financed by the IMF and creditor countries. Naturally, it encountered resistance and objections, and tends to be considered an extreme and absolute exception to the philosophy and standard practises governing public finance international relations. However, this initiative allowed precious experience on debt restructuring to be gained, and coordinated and suitable solutions to the payment difficulties of debtor countries to be discussed in international fora, like the Paris Club, an informal group of officials from creditor countries. Similar processes were organised since the 1970's for public debt held by private creditors, in the so-called London Club. After 2013, the Paris Forum was put in place, an annual event, jointly organised by the Paris Club and the rotating Presidency of the G20, convened to promote a frank and open debate between representatives of creditor and debtor countries, on the global evolutions in the terms of sovereign financing and on the prevention and resolution of sovereign debt crises.

In sum, the genie is now out of the lamp, and new thinking has become possible.

13. A TURNING POINT: THE PONTIFICATE OF BENEDICT XVI

After the last financial and economic crisis, and in response to it, the Chinese walls between ethics and finance started to crumble. The demand for more ethics coming from the world of finance became more pressing giving rise to business and policy initiatives for more "sustainable", more ethical finance. In the other direction, there has been a growing interest and a new focus of moral authorities in relation to what is happening in the financial world.

I believe that in the latter context, the Pontificate of Benedict XVI marked a turning point, a significant change in the approach to the ethics of finance, and would like therefore to highlight his contribution.

We have seen that most of the practises of finance and banking took form in Medieval Europe, and therefore in an environment, dominated by Christian values and with fundamental contributions from the Catholic world. Because of the usury question, Catholic thinkers devoted considerable energy to understanding the world of money and credit. They were among the first to identify the primary functions of banking, explore the risks and opportunities of capital and free trade, demonstrate the moral legitimacy of charging interest and uphold the good practises of capital and investment. However, until recently, limited attention was given by modern Catholic thinking to financial questions.

> *Modern Catholic social encyclicals have relatively little to say about financial questions. Even the 2004 Compendium of Catholic Social Doctrine confines itself to very broad statements about finance and foreign debt, and it never really addresses the moral dimension of private and public debt.*
> (S.Gregg, *Debt, Finance, and Catholics*, 2011).

But this picture changed completely with Pope Benedict, a highly praised theologian, a professor, an innovative thinker, elected to manage the Catholic Church at a particularly turbulent and challenging time.

> *I think that God, if he was going to make a professor Pope in the first place, wanted this element of thoughtfulness and precisely this struggle for the unity of faith and reason to come to the fore.*

In the book interview with Peter Seewald (*Light of the World*, 2010), Pope Benedict singles out "thoughtfulness", this "characteristic trait" of his, this "particular feature of German cultural history" to be the defining element of his mission, and places it at the root of his election to the Papal See. He added that "to-day it is still the major task of the Church to unite faith and reason with each other", putting this "task" at the heart of his Pontifical programme.

Benedict in the same interview goes on to examine the tragedies of our time, from crises to conflict and climate change, which appear in striking contrast with the enormous progress mankind has made in all fields.

> *[But] what is progress? – asks the Pope. Progress is knowledge (…) and (…) power. [But] an essential perspective is lacking, namely the aspect of the good (…) what is good for man and the world. (…) The ethical aspect, of which responsibility is a basic part, has essentially to a great extent been left out. (…) we see how enormously man' power has grown. But what did not grow along with it was his ethical potential (…) [progress has not been] considered in moral terms. [We need] a new deeper moral awareness.*
> (*ibidem*).

Pope Benedict links the main crises of our time to a lack of ethics. At the same time, he points out encouraging signals of a fundamental change underway.

> *In view of the threatening catastrophe, there is the recognition everywhere that we must make moral decisions. There is also (…) awareness of a global responsibility for it; that ethics must not only refer to one's group or one's nation. (…) To this extent, a certain potential for moral insight is present. But the conversion of this into political will (…) and actions (…) [is difficult]. (…) this is a challenge for the Church. She not only has a major responsibility; she is, I would say often the only hope.*
> (*ibidem*).

Finally, Benedict from this perspective draws insightful implications about finance. Asked about the piling up of Government debt to heights never seen before, the Pope answers going straight to the point:

> *Naturally, [it is a big moral problem], because we are living at the expense of future generations. In this respect, it is plain that we are living in untruth (our underlining). We live on the basis of appearances, and the huge debts are meanwhile treated as something that we are simply entitled to. (…) Above and beyond the individual financial plans, a global examination of conscience is indispensable. The Church has tried to make a contribution in this regard with the encyclical* Caritas in Veritate.
> (*ibidem*).

It is interesting to note that Benedict places the issue of filling the gaps in the ethics of finance at the core of his magisterium on "reason and faith",

"truth and love". This suggests that ethics in finance requires both a better understanding of how finance works and what it can contribute to the common good, and then the enunciation of ethical principles able to guide behaviour and orientate the conscience. But he elaborates more on this point in the encyclical.

14. THE NEXUS LINKING KNOWLEDGE AND VALUES

The *Caritas in Veritate*, issued in 2009, is devoted to social and economic development. It explores and extends the concept of development as "integral human development", and – in a rather lengthy and wide-ranging narrative – applies it to several important topics relevant for developmental policies and strategies: from inequality to technological change, from human rights to poverty, from globalisation to the environment.

The most innovative part of the encyclical is in my view in its philosophical structure that is clearly explained at the beginning, and illustrated later with examples and applications throughout the text. The essence of the argument lies in the inherent link between Truth and Love, Knowledge and Solidarity. Benedict intends to complete the loop, adding to the sequence pointed out by S. Paul of "veritas in caritate", the inverse and complementary sequence of "caritas in veritate". In other terms, as the search for knowledge that has driven and drives humanity has to be informed by passion, social cohesion and values, so – in the other direction – the commitment to the common good, solidarity and brotherhood has to rely to a rigorous pursuit of truth, an investment in reason and knowledge. In the different topics addressed by the encyclical we see how the two worlds interact and impact on each other in different ways. But – above all – they cannot live and operate without one another.

> *Truth needs to be sought, found and expressed within the "economy" of charity, but charity in its turn needs to be understood, confirmed and practised in the light of truth. (…) Only in truth can charity be authentically lived. Truth is the light that gives meaning and value to charity. That light is both the light of reason and the light of faith.*
>
> *Without truth, charity degenerates into sentimentality. Love becomes an empty shell (…) it falls prey to contingent subjective emotions and opinions (…) Truth frees charity from the constraints of an emo-*

tionalism that deprives it of relational and social content, and of a fideism that deprives it of human and universal breathing-space.

This message appears particularly relevant in the "present social and cultural context" of wide-spread relativism. Values have to be put at the foundation of human development.

Adhering to the values of Christianity is not merely useful, but essential for building a good society and for true integral human development. [A world of] charity without truth would be more or less interchangeable with a pool of good sentiments, helpful for social cohesion, but of little relevance. (…) Without truth, charity is confined to a narrow field devoid of relations. It is excluded from the plans and processes of promoting human development of universal range, in dialogue between knowledge and praxis.

Development, social well-being, the search for a satisfactory solution to the grave socio-economic problems besetting humanity, all need this truth.

"Caritas in veritate" – concludes the Pope – "is the principle around which the Church's social doctrine turns".

This "principle" can be translated then in practical "criteria that govern moral action". The encyclical goes on to illustrate several of these practical applications in different fields of the development problematique. However the most important contribution is in the new and innovative conceptual framework, and in the fundamental programme of work that I believe it implies. The encyclical in fact opens the way to a new perspective on the relationship between ethics and economic activity.

15. THE ETHICAL FOUNDATION OF FINANCE

The application of the new "principle" of "caritas in veritate" to the world of finance is in par. 65 of the encyclical.

Finance (…) after its misuse, which wreaked such havoc on the real economy – now needs to go back to being an instrument directed to-

> *wards improved wealth creation and development. Insofar as they are instruments, the entire economy and finance, not just certain sectors, must be used in an ethical way so as to create suitable conditions for human development and for the development of peoples. It is certainly useful, and in some circumstances imperative, to launch financial initiatives in which the humanitarian dimension predominates. However, this must not obscure the fact that the entire financial system has to be aimed at sustaining true development.*
>
> *To-day we hear much talk of ethics in the world of economy, finance and business. (…) Banks are proposing "ethical" accounts and investment funds. "Ethical financing is being developed (…) and the system of ethical certification is spreading (…) These processes are praiseworthy and deserve much support. Their positive effects are also being felt in the less developed areas of the world. (…) Efforts are needed – and it is essential to say this – not only to create "ethical" sectors or segments of the economy or the world of finance, but to ensure that the whole economy – the whole of finance – is ethical, not merely by virtue of an external label, but by its respect for requirements intrinsic to its very nature.*

Finally,

> Financiers must rediscover the *genuinely ethical foundation* of their activity (our italic).

We see here a clear shift in the approach. Ethics is not something external that from the outside imposes limits and constraints to financial activity. Ethics on the contrary is at the foundations of the financial system, it is the basis of finance. Without it, finance cannot operate effectively, cannot exist. The presumed dichotomy between an "ethical finance" and a "finance" *tout-court* is an oxymoron, a contradiction in terms. It does not stand. As we have seen above, in the world before the encyclical, finance was generally seen as taking place outside an ethical framework. Finance was tolerated and generally accepted simply because it was useful and in high demand, but it had to be checked and strictly controlled for ethical reasons. It required a normative framework defining limits obligations and safeguards. It was a sector ethically at risk. Now, in the new perspective, not only ethics is not separate and separable from finance,

but it represents an essential component of a well-functioning financial sector. Ethics is the foundation of finance.

16. ETHICS AND SOCIAL CAPITAL

Pope Benedict's Copernican revolution in the ethics of finance is based on "truth" (veritas), i.e. on a deeper and more analytical understanding of how financial markets work. There are several reasons why ethics is essential for financial activities. Let us review briefly the main ones.

a) Ethics and trust. Trust is the essence of a financial transaction. This is clearly understood when trust is missing, i.e. in the case of a bank-run or when there is a credit crunch due to lenders not trusting their customers. A perceived lack of ethical standards undermines the credibility and the reputation of the industry, affecting the use of financial tools and services, the insurance penetration rates, access to equity and securities markets etc.
b) Ethics and fraud. Crimes, scandals, mismanagement in the financial sector have had a negative impact on the functioning of financial markets. This impact consisted in direct costs for fines sanctions and controversies, but also it has alienated the sympathy of the public opinion (more taxes and regulatory burden), imposed higher compliance costs.
c) Ethics and risk. Risk management follows its models techniques and science based standards. But not everything can be precisely measured and tested. Moral judgement needs to be exercised as well, for instance in striking the right balance between excessive risk-taking and excessive risk aversion. Understanding correctly the risk profile of the clients, and offering to them products that match that profile is not a purely technical or formal process (think for instance of the mis-selling of risky financial products).
d) Ethics and asset management. In investment and portfolio management, ethical considerations should play a role, and they increasingly do so. Responsible investment looks beyond the contingent and short-term aspects. Green social and corporate governance factors affect the quality and profitability of the assets.
e) Ethics and professionalism. The quality of financial services depend on the commitment and professionalism of the people working in the sector. Investing in human capital, working in teams and keeping a strong orientation towards the customer and her satisfaction has to be

based on a strong foundation of ethical norms. The market not guided by ethical standard is affected by information asymmetries, transaction costs, conflicts of interests that prevent its efficient working (market failures). Good faith and correct commercial practises go well beyond the formal requirements of "compliance" to laws and regulations.

f) Ethics and labour management practises. The issue of compensation and wage determination has been discussed and subject to much controversy. In general, public opinion strongly feels that this issue cannot be left to standard labour market and negotiating mechanisms (individual and collective). The same is true of productivity arrangements and staff involvement in the conduct of the enterprise. There is an ethical component that cannot be ignored.

It is widely understood and recognised that at the foundation of a functioning financial sector there is a set of rules and regulations, and an architecture of institutions providing supervision, regulation, oversight, resolution mechanisms, deposit guarantees, etc. This framework has a fundamental impact on the quality of the market, and of the services it is capable of intermediating. It is part of the "social capital" of an economic and financial system. But this is only the tip of the iceberg. Because underneath the formal regulatory and institutional structure there are ethical foundations that ultimately drive the behaviour of individuals and enterprises, and create the conditions for good performance. This foundation has a profound influence on the mind-set, and the heart, of the people that supply financial services, or demand them. It involves the culture of risk and the value of thrift, financial education and the sentiment of the public opinion.

Actually, the relationship between ethical norms and financial regulation is a complex one. An appropriate balance should be established between ethical norms and formal legislation and regulation. Often excessive or formalistic regulation ends up being counterproductive. A gap in ethics cannot be corrected merely by a surplus of legal norms and intrusive supervision. In a police State not necessarily law and order prevail. Ethical capital is an integral and fundamental part of social capital.

> *Let the laws be clear and simple; let the entire force of the nation be united in their defence.*
> (Cesare Beccaria, *On Crime and Punishment*, p. 56)[17]

17. WHY BANKS ARE SPECIAL: THE TREATMENT OF INSOLVENCY

Banking insurance and finance are not like any other sector of economic activity. They have a special nature, and therefore are treated differently from the other sectors. Take for instance the supervisory structure. Finance is much more regulated and supervised than any other sector of the economy. Moreover, in many cases Governments interfere with moneylending and banking either by entering the equity capital of banks (nationalisations) or by setting up their own banks. In Germany an important part of the banking sector is made up of public banks owned by local authorities, e.g. Landesbank. An extreme case was that of Italy that before the sweeping reforms of the 1990's had most of its main banks belonging to the central Government. Banking was then considered part of the tasks of the public administration, regulated by a kind of public law. Now the situation has completely changed, and the Government in Italy has exited the banking sector altogether. But this is not the case in many countries, e.g. Germany, and it is frequent that in response to banking crises or financial instability the Government intervenes by taking control or "saving" banks; which would not happen so frequently for other kinds of corporations. The treatment of bank insolvency is a very clear illustration of how and why banks are "special", and different from the standard case of corporate bankruptcy. To the extent that a special term is used to refer to bank bankruptcy, i.e. bank "resolution". Let us discuss the instance in some detail.

In their book on "The economics of bank bankruptcy law", Marinc and Razvan-Vlahu address the question in a straightforward way: "Are banks special?", and illustrate the implications of this special nature for bank bankruptcy law. "Banks are different from other corporations in several ways making corporate bankruptcy law ill-suited for resolving bank bankruptcies." Five reasons are mentioned to explain this "specialty":

a) Trust in the financial sector is crucial. Banks are subject to runs and other destabilising processes that make timely intervention in case of insolvency crucial. Otherwise, the risk is of "imminent unravelling", loss of trust from the public, and ultimately in case of contagion the collapse of the whole financial sector.
b) A bank failure imposes costs that go well beyond the individual institution involved and its customers. Spill over effects may be substantial. Economists say that bank insolvency creates substantial ex-

ternalities for the economy at large, and that the social cost of a bank failure exceeds the private cost.

c) Banks are subject to prudential regulation and the provision of safety nets, including deposit insurance. The existence of such normative frameworks may exacerbate incentive problems and induce banks to take on excessive risk.
d) Banks rely normally on explicit or implicit government guarantees, which interfere with the effectiveness of bankruptcy procedures in an ex-post sense (i.e. for failing banks).
e) Banks activities are subject to different regulatory and supervisory agencies with different objectives and requirements. This creates possible incoherence and coordination problems. Such problems escalate substantially for cross-border financial intermediaries and operations. Lack of coordination and divergence in bank insolvency regimes lead to inefficient procedures.

For all the reasons above resolving banks and other financial institutions is a much more complex and delicate exercise than winding up non financial corporations, and requires a special insolvency regime. The recent crisis provided a vivid illustration of the kind of dilemma that banks pose when faced with bankruptcy risks. At one horn of the dilemma we find the case of Lehman Brothers. At the opposite one, that of the bailouts of several European banks at the expense of tax payers. Applying to a financial institution insolvency procedures similar to those generally used for non-financial corporations, as it was done for Lehman, led to the catastrophic consequences of the 2007-2009 global collapse. That is: systemic instability, risk of melt down of the whole world financial system, standstill of the wholesale funding and interbank market, severe economic recession, dramatic loss of value added incomes and jobs. At the other end of the spectrum, the later experience of failing banks in Ireland, Spain, Portugal, Germany and other European countries led to similarly unsatisfactory outcomes. Recapitalisations and bail-outs with massive injections of public money and nationalisations brought about undesirable consequences that became immediately apparent and had a lasting impact on public finances, the economy, politics and the public opinion of the affected countries. I refer here to the moral hazard implications in terms of excessive risk taking; to the implicit subsidies to the bank shareholders and bad management at the tax payer expense; to the neutralisation of market discipline in promoting efficiency and good corporate governance,

to the distortions introduced in the competitive environment by allowing illiquid banks to compete with well capitalised and well managed intermediaries.

The world found itself caught between a rock and a hard place, as both horns of the dilemma in treating bank insolvency proved to be highly inappropriate. Clearly a more suitable approach has to be found, which implies designing a bank bankruptcy regime that is specific and departs substantially from ordinary insolvency procedures, and takes into account the special nature of banking.

I would like now to focus more on the special functions of banks in the economic and social system, as they have special relevance from the ethical point of view. I will briefly discuss in particular:

a) Banks as liquidity providers;
b) Systemic impact of financial activities;
c) Pervasive moral hazards;
d) Credit creation and leverage
e) Redistributive and social implications.

The point I wish to argue is that while many economic sectors may be considered special and different form one another, banks have special features that are particularly relevant from the ethical standpoint. That is why the ethics of finance is also special, different from the ethics of any other business.

18. BANKS AS LIQUIDITY PROVIDERS

> *Liquidity is a public good. It can be managed privately (by hoarding inherently liquid assets), but it would be socially inefficient for private banks and other financial institutions to hold liquid assets on their balance sheets in amounts sufficient to tide them over when markets become disorderly. They are meant to intermediate short maturity liabilities into illiquid assets and (normally) liquid liabilities into illiquid assets. Since central banks can create unquestioned liquidity at the drop of a hat, in any amount and at zero cost, they should be the liquidity providers of last resort both as lender of last resort and as market maker of last resort.*
> (Willem Buiter, 2007).

It is commonly accepted that liquidity (asset liquidity, market liquidity, funding liquidity etc.) provides a number of public benefits, in terms of positive externalities, both within the financial system, and from the financial system towards the rest of the economy. A liquid foreign exchange market for example may facilitate international trade and the process of industrial specialisation based on comparative advantage.

The importance of liquidity for a functioning economic system has been particularly appreciated in occasion of liquidity crises. It was rightly for the purpose of addressing recurrent financial crises that Central Banks were established and assigned the mission of managing the liquidity of financial markets. For instance it was shown (see Bernstein, Hughson and Weidenmier 2011) in relation to the early US financial history that periods without financial institutions acting as a central bank market volatility was substantially higher during the harvest timje than during the rest of the year. During periods instead with financial institutions such as the U.S. Second Bank (1816-1836) or the Federal Reserve (1915-1925) seasonal liquidity crises disappeared. This proves that the founding of the Fed was a watershed event for improving the liquidity of financial markets.

However, deep and liquid markets do not only depend on effective public policies and central banks. They are the output of the overall financial intermediation process, involving private players, the issuers, investors, depositors and banks. A considerable amount of work has been done to identify the various determinants of market liquidity (see for a survey Marès). Among the many factors having a bearing on liquidity, we may list competitive market structure, transaction costs, the fragmentation of the market (amount of fungible assets), the role of infrastructure, and above all the diversity and behaviour of market participants.

Banks have a special role as liquidity providers, both to their borrowers, in terms of loan commitments, and to their creditors, in the form of liquid demand deposits. Deposits should be seen therefore not only as liabilities, but also as an additional value of the bank. In collecting deposits and making loans banks perform a role that goes well beyond the contractual arrangements with its clients. In providing liquidity to market participants, they provide opportunities for firms of all sizes, and particularly SMEs, to have access to funding, alleviate price volatility, lower the cost of funding. When a bank increases its balance sheet, it contributes also to trading, efficiency in the allocation of resources and financial stability. Positive externalities of intermediation via liquidity are considerable.

This broad function of banking can also be seen from the side of negative externalities. When a bank downsizes its balance sheet, it may improve its profitability and strengthen its capital position, but it destroys value for the economy at large. That is why, when an insolvency thereat materializes, it would not make sense to apply to banks the standard mechanism used in non financial bankruptcy of imposing an automatic stay to manage creditors' coordination problems. Freezing debt repayment in bank bankruptcy would impact liquidity and destroy value. Similarly, the dismantling of the bank liability side, particularly if rapid in case of runs, would also destroy value. The liquidity provision adds value to banks' clients, but makes banks intrinsically unstable. In relation to banks, the coordination problem of being the first creditor to collect is especially acute, being rooted in the withdrawal-upon-demand and sequential-service-constraint features of the deposit contract. Coordination problems between bank depositors are much more severe due to maturity mismatch between assets and liabilities. Besides banks are interlinked. Freezing liabilities would create problems for other banks (systemic risks). That is why coordination problems in the case of failing banks cannot be solved by using an automatic stay and freezing of debt contracts. Deposits in case of bank insolvency need to be guaranteed, and the deposit book should be passed on rapidly to another stable bank. In all this, timely intervention is crucial. Bank runs may be triggered by pure panics. The bank's demise would become in this case a self-fulfilling prophesy

19. THE SYSTEMIC IMPACT OF FINANCIAL ACTIVITIES

After the sub-prime crisis in the US and the sovereign debt crisis in Europe, and in response to those crises, the issue of systemic risk in the financial sector has attracted considerable attention as an academic and a policy topic. The two crises in fact had shown the extent of the damage that a financial crisis may cause to the real economy, and the fact that financial institutions did not internalise the costs of such negative externalities. Addressing systemic risk therefore became a priority of the new wave of regulatory improvements introduced following the crisis, and lie at the heart of the Dodd-Franck Act in the US and the Basel III agreement.

If one bank goes bankrupt, deposit holders may interpret this event as a signal of solvency problems in the entire financial sector and react by massive withdrawals of funds. Bank runs and panic can lead to sharp

monetary contraction, especially detrimental to SMEs, and induce a recession. Empirical research has confirmed that the costs of bank crises are high.

In order to avoid systemic crises, deposit insurance and public interventions such as bail-outs or even nationalisation are standard instruments. However, such remedies create problems too, by encouraging excessive risk taking. Bagehot, as early as in 1873 had introduced the idea, still popular now, that in order to prevent systemic crises central banks should lend at a penalty rate to illiquid but solvent banks, against good collateral. However, it is not easy to know when a bank in distress is insolvent, or merely illiquid. In practise regulators are often reluctant to close down insolvent banks, because it is difficult to distinguish between illiquid and insolvent institutions, it is easier to stem contagion risk by rescuing troubled banks than liquidating them. Sometimes forbearance is motivated by motivation concerns, when regulators do not want to admit their errors. The second round systemic impact therefore, due to regulators and policy responses, are often not less harmful than the first round ones.

Firm size is typically considered the main driver of systemic risk exposure, and large banks are generally thought of as being the systemically important ones. However, there is growing evidence in the literature (see Hovakimian, Kane and Laeven, and Varotto and Zhao), and in practise, that size may not be a persistent determinant of systemic risk, nor be a prominent contagion factor among banks. The case of Northern Rock is often cited as an illustration of the fact that a relatively small bank can have a high contagion potential. Let us recall that only days before its demise, the UK Financial Service Authority had stated that the bank "is solvent, exceeds its regulatory capital requirements, and has a good quality loan book". More recently in 2016, four small Italian local banks were resolved applying the new EU bail-in regime. Although their size was negligible in relation to the size of the market, the case risked determining systemic effects and caused alarm pushing the Government to introduce corrective measures (compensation for a few most vulnerable bond holders).

Beyond size, other factors play a role in determining exposure to systemic risk and contagion possibilities, among which higher leverage, lower tier 1 capital and interconnectedness. Therefore not only "too-big-too-fail" matters, but also "too-complex and too-interconnected-to fail".

Interconnectedness is a key feature of the financial sector. Among the various sectors, finance is the most integrated into the structure of the

real economy. Other service sectors, such as energy, transport and infrastructure, are also closely interconnected with industrial production. But finance beats them all. This is essentially due to the payment systems and payment functions that operate through banks and other financial intermediaries, and affect all economic transactions. A financial crisis reverberates immediately therefore into a collapse of trade and economic activity. More broadly, the importance of trust and public confidence, as social capital, in financial transactions plays a role here. Add that finance is a rather technical activity, and that the level of information and financial education of the customers and the general public is relatively low and of poor quality.

That is why the issue of systemic impact and contagion concerns not only systemically important and global financial institution (G-SIFIs), which are subject to specific new regulation and requirements, but to some extent all banks and financial intermediaries.

20. PERVASIVE MORAL HAZARDS

Whenever safety nets, public subsidies and Government guarantees operate, inevitably moral hazard considerations apply. But in no other sector of the economy moral hazard is more intensive and pervasive than in finance. And *pour cause*! For the very reason that "finance is special", and therefore more highly regulated and more sheltered than other sectors.

Deposit insurance, implicit and explicit Government guarantees create incentives in banks for excessive risk taking, distort competition between banks, and undermine the role of market discipline. Furthermore, moral hazard is more virulent because deposits are collected normally from several small and uninformed savers with limited monitoring abilities. This contrasts sharply with the case of non-financial corporations, where there is in general a smaller number of creditors, and one of them (i.e. a bank) has a special role in monitoring. Hence, deposit guarantees do not usually apply to large depositors, as in the case of the new banking resolution regime in the Eurozone, leaving them subject to bail-in procedures.

In the case of failing banks, moral hazard can have particularly harmful consequences. During the 1980's US Savings and Loans crisis, there is evidence that weakly capitalised thrifts engaged in moral hazard behaviour not only undertaking excessively risky activities but also illegally stealing from their institutions (looting). In the crisis of Mexican banks,

it was also shown that banks engaged in “related lending”, i.e. lending to corporations owned by bank owners.

Opaqueness, implicit government guarantees and deposit insurance create an environment that enables the survival of undercapitalised banks, so called “zombie banks” (Kane). Such banks are highly exposed to the risk of morally hazardous behaviour, determining substantial costs for the economy as a whole. These banks in fact no longer perform their role of monitoring their borrowers, and therefore end up distorting competition for funding and displacing well-managed borrowers.

Moral hazard and conflict of interests, often induced by measures aimed at promoting financial stability, create ultimately themselves a threat to financial stability. They pose to regulators and public authorities a challenging task. Sometimes regulators fall into the temptation of reacting by increasing the regulatory burden, raising capital requirements, imposing costly separation between the core banking activities of retail lending and investment (narrow banking). But these are palliatives. Moreover, excessive regulation has heavy undesirable effects and does not guarantee the elimination of moral hazard.

The presence of cross border banks complicates the picture further, as banks are subject to different regulators and sometimes-conflicting arrangements. An internationally agreed framework of common institutional mechanisms would be necessary to make cross border banking work smoothly.

In sum, the dense network of institutional safeguards and arrangements governing banking and financial intermediation, due to the “special nature” of the banking industry, create an environment of ethical risk and proneness to moral hazard.

Ethics then should come at the centre stage.

21. CREDIT CREATION AND LEVERAGE

The mechanisms through which banks create value added and wealth have always raised mixed feelings of astonishment wonder and suspicion. Even though bankers are often called “intermediaries”, they certainly are a special brand of “traders”. In fact, in intermediating between borrowers and lenders, loans and deposits, banks do not simply “transfer” or distribute resources. They “create” them.

The economics textbook example of the “credit multiplier” or “deposit multiplier” provides an emblematic representation of this rather esote-

ric and mysterious process of wealth creation. 100 Euros deposited in the bank's vault, assuming a reserve coefficient of 5%, become immediately, and magically, a capital of 2000 Euros that can be lent to needy borrowers and spent for consumption or investment. Financial resources possess to some extent the attribute of "non-rivalry" that characterizes public goods, like knowledge: its use for loans to some borrower does not prevent the use of other borrowers.

Financial leverage is a powerful mechanism capable of magnifying investment gains and losses. Individuals who use borrowed funds to invest are leveraged. Real estates for instance are often purchased with the lender's capital, so that borrowers can use it at the same time it is being paid for. Another example is when individuals engage in financial transactions using margins. Without financial leverage, long-term investment would be impossible. At the same time, leverage increases return volatility and insolvency risks. It is one of the main sources of financial crises in history (see Odekon). And it has plaid a critical role in the last crisis of 2007-2009.

Considering this tremendous power, and responsibility, of bankers in the creation of wealth, it does not come as a surprise that they have been subject to checks and controls from public bodies as part of their mandate of managing and steering monetary policy. One of the main tasks of monetary authorities in fact is to set and regulate money supply, as a tool of macroeconomic management in the pursuit of inflation and economic growth targets. As banks have an important role through the credit multiplier in creating "broad" money, Central Banks have conventionally imposed reserve ratios that constrain the ability of ordinary banks of influencing the quantity of money.

We may then ask: have Central banks been able to neutralise or mitigate the extraordinary powers of bankers?, and in so doing have they re-established the primacy of public policy over money creation? Lately this does not seem to have been the case. Let us see what Central Bankers themselves have to say on this point.

The Bank of England's 2014 Quarterly Review contains a detailed description of how money creation works in the UK, rejecting orthodox theories of money creation (see McLeay et alii, 2014).

The reality of how money is created to-day differs from the description found in some economics textbooks. Rather than banks receiving deposits when households save and then lending them out, bank len-

ding creates deposits. In normal times, the central bank does not fix the amount of money in circulation, nor is central bank money "multiplied up" into more loans and deposits.

Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created.

In other terms, new deposits are created when banks lend. And when more loans are being paid off than are being created, money in circulation diminishes. That is why Quantitative Easing in a deleveraging cycle plays a fundamental replacement role for inadequate bank credit creation.

Central Banks do not typically choose a quantity of reserves (…) Rather, they focus on prices – setting interest rates. The supply of (…) base money is determined by banks' demand for reserves both for the settlement of payments and to meet demand for currency from their customers (…). So reserve creation responds to demand for bank loans, rather than driving it.
(*ibidem*).

Victor Constancio, Vice-President of the ECB, argues in a similar vein:

It is argued by some that financial institutions would be free to instantly transform their loans from the central bank into credit to the non-financial sector. This fits into the old theoretical view about the credit multiplier according to which the sequence of money creation goes from the primary liquidity created by central banks to total money supply created by banks via their credit decisions. In reality the sequence works more in the opposite direction with banks taking first their credit decisions and then looking for the necessary funding and reserves of central bank money. (2011).

Therefore, in money creation commercial banks have a prominent role to play.

> *There is no evidence that either the monetary base or M1 leads the credit cycle, although some economists still believe this monetary myth. Both the monetary base and M1 series are generally pro-cyclical and, if anything, the monetary base lags the credit cycle slightly. Finn Kydland and Ed Prescott (Nobel Prize winners), Federal Reserve Bank of Minneapolis* (1990).

A new literature has emerged in the last two decades shedding light not only on how commercial banks contribute to the creation of money and credit, but also on how the channels of transmission of monetary policy operate (see Kashyap and Stein). The standard hypothesis of a passive mechanical role of bank lending, merely reacting to the signals of monetary authorities in steering reserves and setting interest rates, was put into question (Carpenter and Demilrap). First, the development of financial markets driven by liberalisation, growing cross border operations and technological innovation; and later, the impact of the crisis on monetary policy tools and the recourse to unconventional instruments, changed fundamentally our understanding of the inter-linkages between financial markets and the real economy, and of the policy challenges of stabilisation and growth. Two were the major outcomes: the perception that, in contrast with the conventional view of the deposit multiplier, monetary transmission mechanisms are complex, varied and still underexplored; and that banks and markets have a primary role to play in the policy transmission channels. Central banks cannot by themselves automatically control the monetary aggregates, because there are non-reservable monetary instruments, like mutual funds, that mimic checking accounts; because banks are not just deposit creators, but react to monetary signals through a lending response; and because capital markets provide a variety of funding channels, complementary to bank lending. Against the conventional hypothesis, a banco-centric view of monetary transmission has now spread, which gives banks a key function in the process. This function depends on the ability of banks to offset monetary-policy-induced deposit outflows and on the degree of bank dependence of firms and customers.

Banks then have been recognised to be key players in the monetary transmission mechanisms. They rely on deposit financing and adjust their loan supply schedules following changes in bank reserves. They entertain a special relationship with certain borrowers, like for instance SMEs, that are bank-dependent and cannot easily offset these shifts in bank loan supply.

Thus, not only banks participate actively in money creation, but they perform an important public policy role in the delivery of monetary policy, and therefore in macroeconomic management. They are significant policy actors. The allegory therefore of bankers as King Midas transforming in gold whatever they touch should not appear too much off the mark. Bankers in a certain sense enjoy royal prerogatives. However, together with them, they should also bear royal responsibilities, earn respect and credibility. The ethical standards associated to their mission should be of the highest degree, well above those of other professionals and ordinary citizens.

Bankers, as much as banks, are, and should be perceived to be, "special".

22. REDISTRIBUTIVE IMPLICATIONS: CREDITWORTHINESS AND MERITOCRACY

Peter Praet, member of the Executive Board of the ECB, speaking in July 2016 at a meeting on the transmission channels of monetary policy, highlighted the redistributive impact of the ECB accommodating policy stance:

> *What we have seen is a redistribution of purchasing power among different types of households. Specifically, resources have moved from net savers with a low marginal propensity to consume to net borrowers with a high marginal propensity to consume, creating an overall positive impact on aggregate consumption.*
> (Praet).

There is a considerable, and comprehensible, reticence in discussing how monetary policy decisions, taken by independent monetary authorities, impact on the distribution of income and wealth.

> *This redistribution is an unintended side-effect of monetary policy (…) [that should give a] boost to disposable income (…) [and thus contribute to] supporting consumption and investment.*
> (*ibidem*).

But it should be beyond any doubt that decisions of financial market players and policymakers have a significant impact on personal and functional

income distribution. Actually, it is regrettable that more resources are not invested in the analysis of such an impact, not only to support an informed policy discussion, but also to stimulate if required remedial policy intervention, because the redistributive effects of monetary policy can be largely controlled and corrected.

Bringing economic resources and money where it is most needed: this is the essence of finance. Allocating savings, moving it from where it originates to where it is employed for consumption, investment or public expenditure implies redistributing resources across individuals, social groupings, enterprises, sectors of activity, locations (including cross-border). Financial markets accomplish this allocative function ensuring (under certain conditions) – as all markets do – market clearing and Pareto efficiency. Institutional mechanisms provide for correcting market imperfections and reaching the desired targets of social welfare. Distribution is particularly important as it involves the time dimension, and therefore the relationship between the present and the future, and the assessment of risks and potentials. If finance did not exist, resources would remain where they have been created and not currently used, with people that do not currently need them, and depriving people who need them. And in fact where finance is underdeveloped, durable consumption and investment are monopolized by the rich and powerful, and by the old. Finance then plays *per se* a powerful redistributive role, and by-and-large a fair and positive one. Just ask any start-upper or small firm or young couple.

The risk aspects are particularly relevant in the allocation of financial resources. Thanks to finance, and through financial processes, (Knightian) uncertainty is transformed into measurable and manageable risk. This transformation process appear particularly evident in the case of an insurance contract, where savings are managed to provide protection from future risk. But the logic of foresight, security, precaution can be extended to cover all financial contracts and transactions. In all financial contracts there is an element of risk assessment and risk protection. A functioning financial market enables risk sharing, risk transfer and risk trading.

Inversely, finance allows the maximisation of present and future opportunities. Whenever in fact there is a risk, there is also an opportunity. Placing trust on the ability of people, firms and institutions, to innovate, create wealth and generate streams of future income, is a formidable lever of dynamism and entrepreneurship in an economy and society. To

assess the capacity of ideas and projects to produce fruit in the future, and to promote the role of merit in competition, social interchange and transactions: these are some of the most challenging and rewarding tasks for a financier. Giving people opportunities and encouraging talent and commitment is another important feature of the mission of finance. Creditworthiness and meritocracy have similar etymological roots, and are inherently linked.

Analysing the redistribution implications of financial systems, and their impact on productivity and social cohesion is a promising field of theoretical and empirical investigation, and an important terrain of policy discussions. Our general considerations here should suffice to add another relevant dimension to the special character of the financial industry. Its role in providing protection and opportunities, in allocating resources effectively, and in encouraging foresight and precaution introduce in the output of the industry an element of "public good", or quasi-public good that is not present in other sectors of the economy. A well-functioning and developed financial system therefore is part of the essential public infrastructure of a nation, and of her social capital.

23. THE SOCIAL ROLE OF FINANCE

We have surveyed several aspects of banking and finance that give this industry a special significance and connotation from the ethical point of view.

Banking is not like any other sector of the economy. It is more closely and systemically interconnected with other trades, and their communities. It performs special functions of a "quasi-public" nature, such as liquidity provision, money creation, protection from risk and the transmission of monetary policy. It has particularly meaningful, and worthy, allocative and distributive implications that acquire special value for advanced market economies and pluralist democracies. It is more exposed to moral hazards and conflicts of interest.

The conclusion is that banking and finance have a stronger social role than other sectors, and require therefore stronger ethical foundations. Business ethics – we can say – is a foundation of any economic activity, as it is part of the social capital of a nation and provide an essential infrastructure of a well-functioning market economy. But in relation to finance, given its special nature and significance, ethics plays a bigger role. Standards of ethical behaviour in finance are higher, and expectations

of compliance with those standards are also higher. This not only should be so; but it should be visibly credibly and convincingly so; and should be perceived to be so by the public.

Like other economic agents in the market economy, financiers pursue their self-interest and are driven by the profit motivation, but they have to do it in a way that is highly sensitive to the true interests of their clients and to the general interest. Stronger ethical and deontological motivation is required of bankers and financiers. It is not sufficient to respect the law and behave honestly. Not anybody qualifies for financial jobs. And it is more a matter of professional ethics than skills.

To illustrate this point, an analogy comes to mind drawn from the concept of "professionalism" and its origin in history. After all, financial skilled work can be considered itself a manifestation of such "professionalism", and a very noticeable one. The term "profession" comes etymologically from "the profession of faith" that the exercise of certain tasks and activities, for their special nature called "professions", required of the people that were elected to carry them out. To be allowed to enter these special functions, such people were required to have particular qualifications and training that was first of all of an ethical nature, and only later of technical content. In the high Middle Ages, when "Universities" were established, the three main, and only, professions were Theology, Law and Medicine. To be admitted to University training, students had to "take orders" and demonstrate to be especially devoted to faith and religion. The professional process started then, and had to start, with a "profession of faith".

Mutatis mutandis, we may say now that to enter the "professions" in banking and finance, higher ethical qualifications are required, before and above the specific technical skills and experience that make up a good banker. The difficulty is that in modern democratic and secular societies no formal certification can guarantee such standards ex-ante. But deontological training and so-to-speak "initiation" can be quite useful on that score.

In to-day's world of finance, unfortunately, the awareness of such higher and stricter ethical requirements has been lacking, and the perception of financiers in the eyes of the public opinion, and their reputation has been quite far from this awareness. The credibility of the financial world has thus been affected, and with it the popular sentiment vis-à-vis finance and public trust. This has eroded the foundations of financial activities and made them more complex and less profitable.

24. Towards the Ethical Recapitalisation of the Financial Industry

In the last crisis, the widespread erosion of the ethical foundations of financial capital has become apparent. Even more so in the response to the crisis. To the point that the usefulness of finance for economic growth and development has been put in doubt. A "neo-luddite" attitude has emerged that has preached the need to "definanciarise" the economy. Less finance, more real economy – this was the slogan. The paradox is that this "wind mill fight" took place in the middle of a process, still underway, where the role of finance for global growth and stability was, and still is increasing, and with it its relative size in relation to the real economy. In an insightful report of 2012 (Bain Report), titles *A World Awash in Money*, we read:

> *The relationship between the financial economy and the underlying real economy has reached a turning point. The rate of growth of world output of goods and services has seen an extended slowdown over the recent decades while the volume of global financial assets has expanded at a rapid pace. By 2010, global capital had swollen to some $600 trillion, tripling over the past two decades. Today, total financial assets are nearly ten times the value of global output of all gods and services. (…) To navigate the shifting currents of global growth in a time of capital superabundance will require financial market participants to recalibrate their expectations, (…) and exercise enormous investment discipline.*
> (Bain Report 2012).

The 2014 Geneva Report on "Deleveraging? What deleveraging?" echoes the previous analysis and comes to similar conclusions:

> *Contrary to widely held beliefs, the world has not yet begun to delever and the global debt-to-GDP is still growing breaking new highs (…). Deleveraging and slower nominal growth are in many cases interacting in a vicious loop, with the latter making the deleveraging process harder and the former exacerbating the economic slowdown. Moreover, the global capacity to take on debt has been reduced through the combination of slower expansion in real output and lower inflation.*
> (Geneva Report 2014).

The jury is still out on whether such patterns are pathological and extraordinary, and will be brought back to normality after a full recovery out of the crisis, or instead they represent a "new normality" requiring unconventional policy responses in the medium term and in-depth structural reforms. The academic and policy discussion on this point is still raging and we can only hope that they reach soon more conclusive results providing firmer indications to policymaking (as an example of opposite points of view, see Cecchetti and Kharroubi, and Levine). I believe that in the post-crisis scenario the impact of finance on growth potential has become much greater than before, due to the growing uncertainties that economic agents are facing (related for instance to aging, climate change or terrorism), the need for long-term investment and to global interdependencies requiring in-depth governance adjustments and risk sharing mechanisms. I believe therefore that there is still scope for a growing financial sector, relative to the rest of the economy, even if this will require considerable adjustments in the governance mechanisms (e.g. strengthening of global regulation), more innovation and transparency, and more financial education of the public. But it may well be the case, as Cecchetti for instance argues, that there Is a limit to the size of the financial sector after which productivity growth and innovation are negatively affected (see also Samargandi et alii).

Under any circumstances however, we should avoid falling into the trap of prejudice and disinformation. And it is undoubted that the ethical crisis of finance has fed both prejudice and disinformation. Reconstructing therefore public confidence around the mission and role of finance is a precondition for better understanding how to navigate in the unchartered waters the global economy finds itself in, and put on the right track the relationship between financial development and economic growth.

It is undoubted that the last crisis has had a pervasive and disruptive effect on the ethical foundations of finance, or perhaps that such foundations (or lack thereof) have been at the root of the financial crisis itself. The crisis in fact has shown to what extent the world of finance is undercapitalised from the ethical point of view. But in response to the crisis a refoundation of finance has been started. A foundation relying on stronger ethical bases has been perceived as imperative, and is now underway. The tide has turned, and there is now a new awareness in the financial industry.

The time is ripe then for a new beginning in the relationship between ethics and finance, based on stronger and firmer conceptual foundations.

25. THE NEXT STAGE IN THE RELATIONSHIP BETWEEN ETHICS AND FINANCE

We started our story tracing back into the distant past the unresolved antagonism between ethics and finance. In the gift economy that characterized exchanges in traditional communities, lending at interest represented a threat. It undermined the network of solidarity and generosity that defined those communities. A family, a village, a religious community, an association of friends, a club, must work on the principle "one for all" and "all for one". Exchanges are to be grounded in personal relationships and informal reciprocities. Therefore, one should lend "without expecting any return". "If you lend only where you expect to be repaid, what credit is that to you?" (Sermon on the Mountain).The exception was also consistent with this ethical framework: you may lend with interest to a stranger, and only to him. Because he is not like your fellow compatriots, he is not your brother, and he does not belong to your community. He is just a foreigner. This was our starting point.

Then we described the logical and historical steps that marked the evolution of this relationship between ethics and finance. From outright opposition to separation and segregation. From the dichotomisation between an ordinary finance and an ethical one, between responsible investment and investment tout-court, to the establishment of new linkages. Until more recently, a new approach has emerged that places ethics at the foundation of finance, not just the "sustainable one", but any finance and all finance.

We can now turn full circle and go back to where we started. And make one step forward.

If finance is not the antithesis of the common good, but on the contrary, finance cannot be effective, perform its role, and even exist, without ethics, without being based on a foundation of ethical principles; then finance can also become an instrument of ethics, a tool for making ethics more effective, a foundation of the gift economy. The world of solidarity and generosity can, and should rely on the operation of financial mechanisms.

From ethics in finance to finance in ethics.

26. LEVERAGE FOR GOOD: THE NEW FRONTIERS OF SOCIAL INVESTMENT

The world of solidarity and charitable action is undergoing an in-depth rethinking and is shaken by a wave of innovation and structural change.

At the heart of this process of change is the role of finance bringing new tools new players and a fundamentally new logic into the working of solidarity intervention.

In his book on *Leverage for Good. An Introduction to the New Frontiers of Philanthropy and Social Investment*, Lester Salamon emphatically speaks of a "significant revolution" taking place in the world of charitable initiatives in America, and world-wide.

> *American philanthropy is in the midst of one of its most turbulent and interesting transformations in nearly a century. The changing terrain of charitable giving is evinced by an at-times baffling proliferation of new actors, new tools, and new organizations, challenging everything from philanthropy's traditional ways of doing business to how we think about defining social objectives.*
> (Salamon 2014).

It amounts – in Salamon's view – to a new paradigm, a kind of "Big Bang" of philanthropic innovation and liberalization, that is still in its infancy, at the stage of the "hundred flowers", and therefore implies experimentation trial-and-error and the proliferation of a variety of ideas. Moreover, it is taking place "at the bottom of the pyramid", following a bottom up process, rather than being planned and steered from above, and awaits still a conceptual and normative systematization.

The starting point is the deep unsatisfaction with the effectiveness and capacity to deliver concrete results of past and present efforts, and a sense of frustration and deception with the broken promises of many, albeit well intentioned and strongly motivated do-gooders. This has led to taking distance from the dominant grant-centric perspective. It is virtually never the case that a stand-alone grant solves the entirety of a social problem, or allows us to scale impact"; which do most practitioners normally acknowledge. It also pushes to adopt a problem solving approach in selecting the tools of intervention, rather than the conventional ad-hoc piecemeal and supply-driven attitude. It looks for a "*more expansive way of thinking about society's most intractable problems*", whereby opportunities are expanded and effects are multiplied in a "*self-sustaining process capable of bringing permanent solutions*."

The way forward has two main features:

1. First, a "*bewildering array of new instruments and institutions*" have been created: loans, loan guarantees, private equity, social "stock exchanges", bonds and particularly social impact bonds, secondary markets, securitisation, investment finds etc. (For an example of an innovative proposal, see Bonnici).
2. Philanthropic work has been adapted to "*fit into a larger context occupied by private and public*" players. This requires that it becomes "*conversant in the language and needs of private and public finance*". Solidarity institutions have to operate as "philanthropic banks".

This new context amounts to a "complex finance eco-system" that goes well beyond traditional solidarity mechanisms. Beyond grants. Beyond traditional foundations, involving a host of new actors, such as capital aggregators, social enterprise brokers, internet portals etc. Beyond bequests: "*not simply through the gifts of wealthy individuals, but also from the privatisation of formerly public or quasi public assets or the establishment of specialised social purpose investment funds*". Beyond cash: using barter arrangements, internet capabilities, and in-kind assistance mechanisms.

> *Leverage is the mechanism that allows limited energy to be translated into greater power. (…) In the philanthropic world it means (…) [going beyond] earnings on foundation assets or the annual contributions of individuals to catalyse for social and environmental purposes some portion of the far more enormous investment assets resident in banks, pension funds, insurance companies, mutual funds, and the accounts of high net worth individuals.*
> (*ibidem*).

The new philanthropy therefore is "more diverse, more entrepreneurial and investment orientated, more global, and more collaborative".

> *The new frontiers of philanthropy engage a broad assortment of private financial institutions, including banks, pension funds, insurance companies, investment advisors, specialised investment funds, and foundations that function as philanthropic banks.*

Finance and leverage give to ethics an extra-gear, greater effectiveness and – with it – more credibility and a broader appeal. A new paradigm

of ethical work and solidary has been born. The challenge now is to bring it from the fringe to the mainstream.

27. THE POISON OF GIFTS: LIMITS OF THE GIFT ECONOMY

We are at the beginning of a process of structural transformation. Certain tools that appeared only recently new and innovative have now become a mature industry: microcredit for instance has been growing exponentially and looks now capable of mobilising a potential market of $250 billion worldwide. Other tools are under experimentation or have not been invented yet.

The driving force behind this transformation is the fact that the traditional mechanisms of social intervention for fighting poverty and building cohesion in our communities have proved to be largely unsatisfactory. Large public welfare programmes have become costly and bureaucratic. Growth oriented macroeconomic policies have not had an impact capable of trickling down to the benefit of the most vulnerable groups in society. Modernization and economic progress have brought about inequalities and social decay for those people and communities negatively affected. It is not surprising therefore that the public sentiment has reacted sometimes with cynicism and self-centeredness, a sentiment that unscrupulous politicians have often exploited to foment populism, egoism, intolerance and resentment.

Several streams of radical criticism vis-à-vis solidarity approaches have created a negative environment undermining the commitment to ethics and the motivation for responsible behaviour. Let me mention a couple of examples: first, the anthropological critique of the gift society, and second, the debate over the effectiveness of official development assistance.

The most stringent and disrupting criticism of the gift exchange, and of the economic system based on it, comes from the seminal work of anthropologists conducted in the first half of the 20th century. The main authors focusing on the concept and practise of "gift" are the Polish Malinowski and the French Mauss (see more recently Lewis Hyde). These authors conducted original work on the primitive communities of Melanesia in Papua New Guiney aimed at highlighting the meaning and value of gifts and their role in traditional societies. Particular attention attracted the intriguing practise of the "Kula ring", a gift exchange system studied by Malinowski whereby the inhabitants of the Trobriand islands would travel very long distances over dangerous seas simply to give gifts to their

neighbours without any guarantee of a return. The importance attributed to gifts and gift exchanges is due to the fact that they play a fundamental role in building communities and in establishing and maintaining social order and relationships. The question is what kind of social order and what communities are created by the gift economy. Malinowski showed that the Kula exchange system served to reinforce status and authority distinctions, since the hereditary chiefs own the most important valuables and assume responsibility for organising the ocean voyages and gift rituals. There are non-altruistic motives for giving gifts, because even when formally reciprocity is not expected, substantially an exchange takes place in terms of honour and nobility recognition. Relationships nurtured by gifts are always asymmetrical; the giver has always a higher status than the receiver. "Pure gifts", i.e. gifts that do not impose reciprocity, are given to preserve landed estates identified in particular kin groupings and maintain their places and ranks in the social hierarchy.

Gifts, and solidarity, therefore – according to these studies – are never "free". They always create social bonds with some kind of obligation to reciprocate. They put people under obligation. This effect, that represents one of the main aim and motivation of the gift exchange, is generally referred to as "the poison of gift". A gift that is not returned, or is not even expected to be returned, signals inequality of status, dependency, subordination. We may interpret the stigma associated to receiving alimony or being on welfare as coming from there. Correspondingly, an exchange not based on the gift concept, signals independence, absence of social ties bonds and entitlements, freedom, non-recognition of the order and values of a community. It characterises therefore a stranger, a foreigner, one that does not belong to the community.

This analytical work can provide the basis for a radical criticism of the gift economy, and it has been used in that direction. Conversely, it has highlighted the merits of market exchanges based on the values of individual freedoms, property rights and equality of all before the law.

However, this contrast and opposition of value-systems has in my view been carried too far. Reality is much more balanced and harmonious, and many contributions in the literature support this stance. Indeed, "true gifts" or non-reciprocal gifts not only are possible, and valuable, in advanced market economies and democratic societies. But they are widely spread and recognised. Think for instance of the role plaid by voluntary work and cooperative partnerships. But doubts have been instilled on the operation of a gift economy, and awareness has been raised on the possible

limits of traditional solidarity. Theoretical, or worse ideological confrontation have to be replaced by concrete, informed and evidence based analysis.

28. IN SEARCH OF A THIRD WAY BETWEEN PRIVATE CHARITY AND PUBLIC WELFARE

A second example of criticism of interventions motivated by solidarity can be drawn from the debate over Official Development Assistance and its impact on poverty and underdevelopment. In his iconoclastic and widely acclaimed book "The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics", William Easterly reviewed critically the efforts by Western Governments to pour aid and fill the financing gap to invest in the developing world. Conditionality imposed on third World countries policies did not work. There was little incentive for recipient Governments to improve their policies. Debt forgiveness regimes produced the same moral hazard, as authoritarian Governments considered forgiveness as a free pass to continue to steal from their peoples' future. Easterly suggested that aid should be tied to prior achievement rather than promises of political leaders. In *The While Man's Burden* (the title refers to Rudyard Kipling's famous poem celebrating American imperialism) Easterly criticised the campaigns of development cooperation agencies and international organisations in favour of foreign aid, and people like Bono and Bob Geldof that spent their reputation on them. Such messianic do-good missions – Easterly believes – are ultimately modern reincarnations of the infamous colonial conceit of yore. The subtitle of the book is self-explanatory: "Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good". In the later essay *The Tyranny of Experts: Economists Dictators and the Forgotten Rights of the Poor*, Easterly chastise development policies focused on expert advice and economic subsidies for failing to address the core of the problem, that is the lack of individual rights. Developed countries often sided with abusive autocrats by lauding their economic presumed achievements and ignoring their dismal human rights records.

Another economist, author of best-selling books is worth mentioning in this context: Dambisa Mojo. In her highly popular book *Dead Aid: Why Aid Is Not Working and How There Is Another Way for Africa*, she focuses on Africa arguing that intergovernmental aid had harmed Africa and should be phased out. The Financial Times summarizes the book's ar-

gument, stating "Limitless development assistance to African governments has fostered dependency, encouraged corruption and ultimately perpetuated poor governance and poverty". World Bank economist Paul Collier in a review of the book stated "Aid is not a very potent instrument for enhancing either security or accountability. Our obsession with it has detracted from the more important ways in which we can promote development: peacekeeping, security guarantees, trade privileges, and governance".

These radical critiques prompted a heated academic and political debate. The most prominent defender of foreign aid and supporter of the view that more development assistance is needed to improve conditions in developing countries, most noticeably in Africa, is Jeffrey Sachs. In his book *The End of Poverty* he argues that only through carefully planned development aid extreme poverty can be eliminated, defining even the target date globally of 2025. Sach's analysis lent support to the UN Sustainable Development Goals programs that was agreed upon by the leaders of the main countries at the UN Millennium summit first, and later restated and relaunched at the 2015 Summit in New York. His calculations showed that if developed countries stick to their commitment to invest in foreign aid 0.7% of their GDP, this would be sufficient to eradicate extreme poverty al-together by the target date. He obviously criticised Easterly and Mojo for providing an alibi to reluctant western Governments to comply with their promises and invest in development. Asked for his views on Dead Aid, Bill Gates stated "Books like that – they are promoting evil".

In a paper published in 2007 with Abdur Chowdhury, I proposed more balanced and mid-way point of view on the issue of the effectiveness of official development assistance, drawing lessons from the European experience. Economic integration and subsidiarity provide the conditions necessary for ODA to produce higher rates of economic growth on a sustainable basis. The experience of Eastern European transition countries, provides an excellent case in point. These countries were assisted by the European Union in their efforts to integrate their economies with those of Western Europe and adopt bold economic reforms conducive to growth. The focus then in the discussion should not be on whether… or…, but rather on at what conditions development aid can be effective.

To conclude, "all that glitters is not gold" in the world of solidarity. And new glitters are coming from the world of finance in search of a closer and more appropriate relationship with ethics. The time is ripe for ex-

ploring a third way approach between private charity and public welfare, both of which have shown limitations, even though it would be inappropriate to think that they could be simply scrapped. The new rapprochement between ethics and finance and the new and promising terms of their relationship enable to create an environment conducive to social experimentation, innovation and best practise.

For all people of good will there is precious and hard work to do.

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Ethics in finance: the experience of sustainable finance in Italy

DAVIDE DAL MASO*

The relationship between ethics and finance is quite complex and can be addressed from different perspectives. I see at least three aspects worth investigating:

- the first is if the principles of business ethics have a specific application in the financial sector;
- the second is how ethical principles steer the decision of financial actors in relation to the purpose of debtors' (borrowers or investees) economic activities;
- the third (on which I will focus more) is to what extent ethics influence society's preferences and become a competitive factor for debtors in the market.

1. Like in any other business environment, moral or ethical problems arise from time to time and professionals have to deal with them, both at individual and organisational level. One might argue that in an over-regulated sector such as finance, it's the law that states what is right and what is wrong and, therefore, an organization that behaves in compliance with law is on the safe side. Unfortunately, it is not that simple. We know that law and contracts are incomplete. There is always room for expectancies that cannot be regulated by formal rules. In this grey area that law cannot cover, it is ethics that is supposed to guide decisions.

The business of finance is particularly sensitive to conflict of interests. Insider trading is a classic. But let's take a very ordinary case, such as lending, and let's apply it in one of the noblest example of business driven by values, the cooperative banks: here, the principle of mutuality, the in-

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ternal democracy, the [theoretical] alignment of interests of different stakeholders (a person can be at the same time shareowner (member of the cooperative), client (both depositor and borrower), employee and member of the board) can create either a magic formula or a complete mess – and it's ethics that makes the difference, not the rule of law.

Another example comes from the news about the role of banks in tax evasion that emerged from the Panama Papers: one of the most respected Nordic financial institutions, Nordea, has been alleged to have helped some of its clients to hide their wealth. The bank regretted that it did have procedures earlier to ensure clients pay the necessary taxes and its CEO added "Compliance is the bank's absolute top priority". Still, Denmark's minister for culture and ecclesiastical affairs, Bertel Haarder, said "ethical conduct will be an important competitive parameter in the future. It won't be enough that a transaction is legal. It also needs to be morally defensible." This statement clearly demonstrates that compliance with law is a necessary but not sufficient condition to run a business. In order to achieve the licence to operate, a company must do more than respect the basics; it has to move beyond and to fulfil the legitimate expectations that come from the society.

For banks and financial institutions in general, social legitimacy is particularly hard to achieve. Historically, lenders do not have a good reputation. The practice of making money with money (as opposed by earning it through labour) has always been very controversial and many religions disapprove interests on lending. In more recent times, the big crisis that (symbolically) started with Lehman Bros bankrupt has been attributed to the opportunistic behaviour of Wall Street greedy bankers. Clearly, it is a rough simplification – but it witnesses how long is the way that financial institutions have to walk to regain public confidence.

In this perspective, codes of ethics are perceived as a further level of regulation that create smoke rather than provide an efficient and credible tool to prevent misconducts. Instead, I believe that they are one of the most effective means that financial institutions have to regain trust: acknowledging the existence of conflicts and clearly stating how they are treated is the basis of the social contract with stakeholders. Companies (and financial institutions make no exception) tend to make very general statements on the importance of their stakeholders, i.e. that they are all equally esteemed: the organisation wants to create value for shareholders and customers and employees and communities and future generations and (…) – which is simply impossible: every person with common sense knows

that in any organisation some stakeholders are more important than others, even if it might be politically incorrect to admit. But not to say who is more important than who just generates the conditions for arbitrariness and ambiguity – that is exactly what an organization should avert. Codes of ethics are not there to create verbose and useless superfluity and to make things more complicated – exactly the opposite: an honest code of ethics helps people to solve problems. It's not by denying the existence of ethical dilemmas that organisations can overtake tangles, but rather by dealing with them with transparency and frankness.

2. What I said above might concern, mutatis mutandis, any business. But in terms of applied ethics, the financial industry has a peculiarity that poses specific questions, which is that its impacts are mainly indirect. Finance is an enabler for someone else's business – that, in turn, generates economic, social and environmental effects. It is not the financial activity itself that emits, say, greenhouse gases, but banks' corporate customers might do. The question then is: is the bank responsible of the consequences of its customers' activities? Legally speaking, in most cases the answer is not. But, as we learned, compliance with legal standards is not enough. The ethical principle of responsibility suggests that one should consider also the repercussions of the activities it makes possible. And, in fact, financial institutions are bitterly criticised for supporting companies that run controversial businesses (armaments, alcohol, pornography …) or manage a "normal" business in way that undermines social or human or environmental capital (for example, violation of human rights along the value chain).

This debate is at the origin of what we call "ethical finance", i.e. a particular way to act as a financial institution that is steered by an ethical purpose. An ethical bank does not finance any business whatsoever, but only those that produce outputs in line with its values. In other words, ethical finance expresses a clear view of the society it wants to pursue. Its mission is to make it real by funding only the economic actors who share this vision. The real innovation of ethical finance is that it overcomes the idea of "neutrality" of financial activity and extends to the capital supplier the responsibility for the effects of the underlying business. Finance is not a goal itself, but a mean. The social legitimation of finance is not given for granted; it needs to be justified by the extent to which it contributes to the achievement of an ethical economy.

Of course, we know that the concept of ethics is relative, not absolute. Ethics is a system of moral rules that are recognised by a homoge-

neous community. When we speak of ethical finance, we should always clarify which ethics we are referring to. Catholic ethics differs from Islamic one – but both are applied by financial institutions that define themselves as ethical. If we push the concept up to the extreme, also mafia expresses an ethical vision (a set of stringent rules, fully respected by its members) and its financial activity is ethical in the sense that it is coherent with the mafia values (maximisation of profits at any cost, code of silence…) – but it is clearly a paradox.

3. We are witnessing a vast phenomenon of change in moral values in the society. After years when economic growth was perceived as the only goal, worth any social cost, today people feel that a new balance has to be found in the economic system and in the society. People's new awareness, raised by social and environmental crises, generates effects in several directions: citizens-voters push their representatives in the political arena to pass more stringent regulations – that, in turn, penalize (or reward) corporates' social or environmental policies; citizens-consumers use their purchasing power (the so-called 'vote with the wallet') and determine the success of companies' business strategies; citizens-employees transfer their values in the organisations they work for, promoting the change from the inside. Like a tide, the new social sensitivity instils the seeds of change at any level.

Finance is not immune to this development – and Sustainable and Responsible Investment (SRI) is possibly the phenomenon that better synthetises it.

SRI consists in the integration of Environmental, Social and Governance (ESG) issues in the investment processes. This means that investors, when deciding asset allocation, not only consider the economic fundamentals (solidity, profitability…) of investees, but also the quality of their ESG policies and practices. In practice, this happens through the use of a set of indicators that measure how the invested company manages the relationships with its key stakeholders (shareholders, employees, customers, communities, suppliers…).

SRI can take different shapes, according to the goals that the investor wants to achieve. Eurosif, the European reference organisation in this domain, defines seven possible approaches[1]:

1. See the b-annual SRI Study http://www.eurosif.org/our-work/research/sri/.

- Sustainability themed investments cover a wide range of themes from climate change and energy efficiency to for – ests and water. Investors' motivations may vary greatly, but it is typical to support particular industries transitioning to more sustainable consumption and production. This can be combined with a belief that a particular theme will outperform the rest of the market over the holding period, or may provide some degree of de-correlation to other investments.
- Best-in-Class assets typically involve selecting the top percentage of companies within a sector using ESG criteria. For example, within the consumer goods sector, in companies eligible for portfolio selection, a portfolio manager might restrict the investable universe to the top 50% based on an ESG rating screen. The relative allocation to the portfolio of the selected companies may then depend on purely financial criteria, but can also be made using a combination of financial and ESG analysis. Other Best-in-Class methods also exist (e.g. Best-in-Universe, Best-in-Effort), and the strategy is also referred to as positive screening.
- Norms-based screening is a strategy that involves assessing each company held in the investment portfolio against specific standards of ESG performance. These standards are based on international norms set by organisations or institutions such as the United Nations Global Compact (UNGC), the OECD Guide-lines for Multinational Corporations and International Treaties. Investors will often use one or a combination of these standards, or they may construct their own standard based on these initiatives. Once companies in the portfolio have been identified in breach of these standards, investors will perform a deeper analysis and take action. This action typically falls into two categories: exclusion from portfolio or engagement with companies.
- Exclusions or negative screening is a strategy that involves removing companies or sectors from the investible universe of the portfolio. There are a number of different motivations and applications of this strategy, from risk management to values-based investing (moral, ethical or mission-based requirements). The exclusion of certain controversial activities is becoming common among European investors. This often includes those prohibited by international conventions, such as the 1997 Ottawa convention on anti-personnel landmines and the 2008 Oslo convention on cluster munitions.
- ESG integration is defined as the explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and

investment decisions based on a systematic process and appropriate research sources. This strategy can be further articulated into three sub-types:

- non systematic ESG Integration, when ESG research and analyses made available to mainstream analysts and fund managers;
- systematic consideration/inclusion of ESG research/analyses in financial ratings/valuations by analysts and fund managers;
- mandatory investment constraints based on financial ratings/valuations derived from ESG research/ analyses (exclusions, under-weighting etc.).

- Engagement and voting on ESG issues, driven in large part by the view that shareholders are stewards of assets who are accountable to their beneficiaries for how they manage those assets. Policymakers and other stakeholders are propagating this view through initiatives like Stewardship Codes and legislation such as the EU Shareholder Rights Directive.

Despite the difficulties in understanding such a fast-evolving market, all studies demonstrate that SRI, however defined and applied, is gaining momentum and it is growing in terms of size and quality. The undisputable success of SRI can is explained by at least two reasons – that, in fact, are two sides of the same coin: market demand and solid business case.

The former is easier to interpret: like in many other sectors, consumers' preference is moving towards products and services that are perceived as 'sustainable' – whatever the final client intends with it. People more and more buy organic food, child labour free garments, hybrid vehicles, eco-certified travels and so forth. Of course, savers do not buy a mutual fund exactly with the same logic the use for a fairtrade banana, because the social dimension of finance, as said earlier, is indirect and therefore less immediate to catch (not surprisingly, SRI more diffused amongst the highly educated and conscious targets). It will take a while to move from the niche to the mass market, but it is only a matter of time.

SRI is in minimal part driven by retail investors. The vast majority of SRI assets come from institutionals. Why do they go for SRI, provided that they don't have to fulfil an intimate moral imperative? The answer brings us to the latter reason of the success of SRI: it works. Empirical eviden-

ce from a huge bulk of academic studies shows that there is a positive correlation between ESG and financial performance. This statement would require a lot of reasoning and statistics to be accepted and this is not the place where to do this exercise. But, to remain on the ground of intuition, we can affirm that the more a corporate strategy is aligned with society's values, the more is likely to achieve success. From this viewpoint, having a good ESG score means being able to prevent [market, legal and reputational] risks and to catch the opportunities created by the new demand of sustainable products and services. In a word, because sustainability is the new competitive factor for success, sustainable companies are less risky and eventually more profitable. Institutional investors don't go for SRI because they are good in a moral perspective, but because, by doing so, they protect their assets and fulfil their fiduciary duty towards their clients.

Now, going back to the initial questions, what is the relation between SRI and ethics? Is it really different from what we called 'ethical finance'? My answer would be that the purpose of SRI is not ethical – or not necessarily. But ethics, in a way, is what makes SRI possible: in a rough simplification, ethics is what people feel is right or wrong. If, in a given social context, polluting the atmosphere with greenhouse gases is perceived as 'bad', those companies that do not reduce their impact will be considered as anti-societal; their licence to operate will be questioned. In this sense, there is a convergence between economic interest and societal interest. An ethical conduct can be economically sensible because is rewarded by the society (and vice-versa). Ethical behaviour is convenient – but behave ethically because is convenient is not ethical. What makes an [economic] action morally valuable is its purpose: the same action has a different moral value depending on the aim for which it is taken.

Here lies the distinction between a [responsible] for-profit business and a social business: the former's mission is to maximise profits and it will take into consideration other stakeholders' interests to the extent in which it creates value that can be, directly or indirectly, monetized; the latter is there to create social value and it is driven by intrinsic motivations. In times of crisis, the former will compress any investment that affects profitability; the latter will reduce margins, but will try to preserve social value creation. In other words, the former considers ethics as a constraint in its objective function; the latter looks at moral goods as a goal to pursue.

Social innovation and impact investment: redefining the social contract

MIGUEL POIARES MADURO*

Wealth creation and with it the financial system and social justice are often perceived at best as separate – at worst as in opposition. This actually forgets the role that the financial system has had historically in the beginning as a way of democratising access to wealth, but this is indeed the view, which has become predominant.

The way the two are often reconciled is by putting the focus on the extent to which wealth creation can create more resources that can be redistributed. And the traditional instrument for that – as the previous speaker mentioned – was the taxation system. But this understanding, in opposition or at best as strictly separated of wealth creation on the one hand and on the other hand of social value, of social infrastructure has shaped the understanding of the relationship between the two domains. An understanding governed by different set of values and pursuing different goals.

This tension has been clearly exacerbated by the financial crisis and the perception that this crisis was linked to inadequate set of values, to a world deprived of ethics and appropriate behaviour.

In my view – and this is the first point I want to make – this tension feeds and is fed by a deeper challenge to the foundation of the social contract on which our societies, our States have been based and worked for decades.

There are two main origins for this deeper challenge to this social contract.

The first one is globalisation. Globalisation is perceived as redistributing wealth between different set of actors. Mobility for example is easier for capital than it is for individuals and in that way then having redistributive effects altering the social contract by virtue of the consequences

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of globalisation. And globalisation is also perceived as affecting the autonomy of State political communities in regulating and distributing the wealth as part of that social contract. So, globalisation puts in question the traditional forum for the governing of the social relationships that are part of that social contract.

The second deeper challenge for that social contract is linked to a variety of structural challenges in our society such as ageing but, I would say, the crucial element for the future in terms of those societal structural changes and the way that it will affect our social contract is the technological revolution. This technological revolution is having and will have extremely important and relevant redistributive impacts. First, because the nature of innovation today and the nature of technological innovation and the products and services that it creates is such that added value in these new products and new services is often very strongly concentrated. And that strong concentration therefore has an impact on equality and has profound redistributive consequences. Second, robotics, artificial intelligence is bound to profoundly impact the nature of employment. Some recent studies estimate that 50% of all jobs that we currently have, 70% of low skilled jobs, will be replaced in a period of 10 to 20 years. I will argue that this set of conditions – globalisation, the structural challenges, the technological revolution – puts us in a situation very similar to that which we historically faced when we had the industrial revolution. The industrial revolution had profound societal consequences and the way to legitimate, to accommodate these consequences was the emergence of the Welfare State. The Welfare State was the answer to the challenge that we historically faced with the industrial revolution. So what we need today is to design and to find what is our answer to this profound challenge which we have in societal terms. In my view, the fundamental part of that answer will come from impact investment. And I believe so because a fundamental part of that answer will need to come from breaking this separation between wealth creation on the one hand and social justice on the other. This can be then by instruments that will internalise social values, social goals in the operation of the financial system and the market economy.

This can be also by pulling on the power of innovation, also not only at the level of products and services but also on the level of public policies. It is in this context that I said that I believe social innovation and impact investment can play a fundamental role.

This is what we try to do in Portugal, by developing a very ambitious social innovation and impact investment program. Our program for so-

cial innovation is the first one also where EU structural funds are being used, is probably in relative terms the most ambitious worldwide.

But in my view it's not enough to have funds, to put money. For this to work, for social innovation to succeed and to deliver what we expect and want it to deliver, we need to change institutional culture. Infrastructure is important, funds are important, people are important, but it is crucial to change our institutional culture, what is often described as the ecosystem. We need an ecosystem that is friendly to innovation, that welcomes and understands impact investment and integrates the set of values that is linked to it.

But the creation of this ecosystem, the change in institutional culture, is perhaps also the most difficult thing to achieve because we are culturally dependent. We have sort of cultural bias on how we understand the world. And therefore one of the most difficult things for those who work on social innovation, on impact investment is to make the others understand its potential because often the potential is understandable only when it is lived. We do not have that reality yet, it is difficult for those to anticipate the potential of something which is totally foreign, stranger to how things have usually been done.

I would like to make a small exercise with you, to try to make this point clear.

Imagine you are in the year 2000 and you have two groups of people that come to you asking to fund a project. The first is a group of very famous professors come and say well we are going to create the best encyclopaedia in the world. It is going to surpass the Britannia encyclopaedia, it's going to surpass Larousse, it's going be the best encyclopaedia in the world because we have the best professors. We have agreements with Harvard, with Yale, with Sorbonne, with La Sapienza, with all the best universities in the world and these people are going to write the entries and the best encyclopaedia you can think of.

And then comes the second group of people, likely younger people, that come to asking for financing tool. Remember, this is the year 2000. You ask "What do you want us to fund?". They reply "We want to create an encyclopaedia. It's going to be a site on the Internet. Everyone can create an entry, everyone can come and edit that entry and write whatever they want".

Who do you think will be funded? The first group, because that was our concept of encyclopaedia. The second is what we call Wikipedia and has become the dominant concept of an encyclopaedia. But until Wiki-

pedia existed, if you would tell anyone mainstream to fund, to put lots of money in it, nobody would have done it because that was not the concept of what an encyclopaedia would be.

This tells us a lesson about the nature of innovation, including social innovation, about the extent of obstacles in terms of path dependency, of cultural bias that need to be overcome. And in order to overcome them what we really need is a holistic approach that works at the level of different institutional variables in order to create the institutional cultural change that we need to set up the ecosystem that is friendly to social innovation and impact investment.

There are decisive elements in this ecosystem. You need more cooperative mentality to fight the silus culture that is dominant in the public sector, but is also dominant in the way that companies work. You need a cooperative mentality. Specialisation is great but increasingly you need to balance that better with cooperation. You need more openness to experimentation and risk-taking. You need a more meritocratic culture, more focus on measurable results and metrics to assess them. And you need – as the previous speaker also mentioned – much more focus on a smaller scale, on decentralisation. The idea is that you can succeed in areas of innovation by starting with a smaller scale, then generalising then expanding it.

It is with this in mind that in Portugal we created our social innovation program and in that program we stressed a lot the instruments that aim at promoting cooperation between actors but also more integrated governance. We also stress very much capacitation, very strong emphasis on that. Also tremendous importance is given to developing new metrics, developing measurable indicators and that in an area such as social innovation and impact investment is a novelty because you don't measure results simply by market return, but because you want to measure other positive externalities which are created, how do you measure that financially?

This is a crucial working where we have to invest much more. And our program also has a tremendous focus both on scalability and sustainability. It has four pillars in this respect.

The first one is what we call capacity building for social investment. We give grants of up to 50.000 EUR to each actor who has a project funded. This money can be used only for capacitation. So the idea is that with the money to fund a project comes a specific funding that is only to be used for capacitation, to strengthen the managerial capacity, to prepare these actors to receive the impact investment.

The second pillar is what we call venture philanthropy matching program. The purpose here is to promote a pipeline of stronger and more sustainable projects. Basically what we do here is we match the founding that comes from foundation, corporations and also other public entities, that are provided for impact initiatives in a logic of venture philanthropy. And the idea is to grow the critical mass of these projects, to then allow them to be in a better position to benefit from the additional two pillars that we have in our program, that are the most substantial.

So these first two are meant to reinforce the capacity of the system to then receive and make use of the two most important instruments. These two most important instruments are one related to innovation on public policies. And it is the social impact bonds. The State or public entities contract with NGOs but can also be private companies, can also be local authorities and often what we have the indication from the first project is that you have a consortium of local authorities and NGOs. Aimed for example at reducing academic failure, drop out rates from school. And what our program does is that, it measures the benefit, the social benefit from the reduction in the drop out rate. This is given a certain value, which is measurable in financial terms; and if that goal is achieved by that program, the State through our program pays to the investors who have an economic return, an economic profit from the investment they have made in pursuing that social goal. So this social impact bonds is the instrument that we have in promoting innovation in public policies. And our expectation is that these projects will be multiple, but on a smaller scale, often at local level. And where a project such as that will work in the area of education, but we also have other areas such as health, employment, social inclusion, then can be generalised for other areas of the country.

The fourth and final pillar that we have is the fund for social innovation. This is actually the first financial instrument for social innovation set up with means of the European Union structural fund. This fund will work at the wholesale level. In the form of equity or partial equity or financing of loans. Through entities that can be banks, can be foundations and often again what we see here is that there are groups forming with banks, foundations, NGOs, social actors, that they will be the retail entities that will contract with Portugal Social Innovation and will provide funds in terms of impact investment.

Now, these are the four pillars through which we try to cover the full range of potential that we have in the area of social innovation and impact investment.

But it's not enough to set up an ambitious program like this one. We have many challenges that we have ahead, many challenges that we have not only at the level of my own country, Portugal, but also Europe. I trust tremendously in the potential of social innovation and impact investment. And I trust very much in this potential to help us addressing the challenges that we have in reconstructing the conditions for the social contract that have been the basis of our society.

But I want to conclude highlighting some of the challenges and the risks that we have implementing this strategy.

The first are political risks. I was a politician for some years so I am well aware of what you have to gain or to lose in investing on a topic like this. This is reason for me why politicians very rarely, particularly in Europe, have not assumed ownership of the idea of social innovation and impact investment. It hasn't been given by politicians often the importance. You have certainly the United Kingdom and the United States, but outside these two countries very rarely it has been taken as a flag, as something that could be politically valuable. And you need politicians to think that it is politically valuable for them to assume ownership and lead and pursue this agenda.

And for me the reason is the complexity. It is very difficult to explain this to people. The advantages, the consequences… What does it mean to internalise in the economy social goals? What does it mean exactly social innovation? What does it mean impact investment? It is not something that you can go to a television and present in a thirty seconds statement. And in fact, if you say "I give 150 million to traditional in the form of subsidies to social actors" you can get, but if you say "I give 150 million to social innovation and impact investment, it's going to be leveraged by financial institution and used to support projects that will produce social goods" that's more difficult to understand.

This complexity means it is difficult to sell but moreover it means something else too. It means it is very easy to manipulate. In Portugal, when we presented this, either we have almost no attention from the media or, when we have, is because someone started to say "Oh, this is the beginning of a privatisation, this is a new form of privatisation" And that's it. You have the label privatisation and immediately you are in trouble. So, the first challenge that we have is how to sell it politically. How to make it politically attractive. And this should be the focus of those that work on this agenda. And I think the goal, the starting point is this. What we say is that we want to create a market economy that is more socially frien-

dly. That's the starting point that acts more in accordance with social values, that's how to pursue this agenda politically.

The second challenge that we have is competition with traditional areas such as philanthropy or the way in which traditionally social actors have played.

In the beginning in Portugal we had many suspicions, reservations from traditional social actors. This is a new area, is not the way we traditionally do things where you got the subsidy to produce a certain social service. The idea of sustainability of a social project is contradictory of the idea how they are perceived. You get money to provide a service. You don't get money to produce something which then gives you a financial return. So, the risks of division, of competition of those who say "No, we shouldn't invest in philanthropy, we shouldn't invest in impact investment" is a very strong one.

And here, again, the focus has to be that these two things are not in opposition they are complementary. Social innovation and impact investment have a plus compared to other traditional areas. They are a system to mainstream social values into all areas of the economy, including when you act for profit.

The third challenge is demand. I often say in Portugal "we have no problem in funding". My fear is, do we have projects with the quality necessary that will justify the funding to be provided? Or do we have investors ready to come with their money to make use of these new financial instruments? This is basically the challenge resulting from the fact that we are creating a new market where it does not exist. And therefore the focus that we have put in Portugal in terms of capacitation and in terms of creating a set of actors that we call activation actors, not to be passive but to be proactive in the search fro example to help the traditional circle of social actors t make use of these new possibilities. Because there is a lot of potential from which you can pull but you need to reform and to capacitate those actors.

And very important in this respect – this leads me to my final point – is visibility. As said, social innovation, impact investment often is on a smaller scale, should start on a smaller scale. But on the other hand, in order to be successful in facing the challenges that I mentioned, it needs to be part and be supported by a broad narrative. In my view, and this is the point that I tried to make at the beginning, this narrative is and could be the role that social innovation and impact investment can have in allowing us to face the challenges for the social contract, in terms allowing us to rebuild the social contract on which society has been founded. Thank you very much.

Internally-driven ethical reconstruction: is it happening?

ROBERT ANNIBALE*

Global corporations – and in particular, those in the financial services sector – face a broadening wave of public scrutiny and a rising level of societal expectations. According to the 2015 Edelman Trust Barometer, financial services and banking remain among the least trusted industries worldwide in the eyes of the public – placing it below the chemicals, pharmaceuticals and energy industries. In the United States, Occupy Wall Street and other protest movements sought to bring public attention and reform to what they identified as a leading contributor to social and economic inequality.

Banks are still recovering from the loss of trust and faith resulting from the global financial crisis. During a time when the financial services sector continues to recover and works to rebuild its reputation, restoring and strengthening public confidence and trust is essential to the future of the global financial system.

The public understands well that we are all stakeholders of the decisions and actions taken within large, powerful financial institutions; and that these decisions have the ability to affect our lives – for good and for ill – whether we are customers or not. Core to Citi's mission and values is a commitment to responsible finance and stewardship, which informs our culture of ethics that drive how we operate, conduct business and lead at Citi.

1. BEGINNING AT THE LEVEL OF THE CORPORATION

For Citi, as for all financial institutions, trust is the necessary foundation of our business. It is our license to operate. Simply put, we cannot ef-

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fectively do our jobs without the ability to maintain the confidence and trust of the people, communities, and institutions we serve. Citi has a number of internal and external processes in place and additional efforts underway that mirror many of the recommendations of Fondazione Centesimus Annus Pro Pontifice's (FCAPP) report entitled, "The Dublin Proposals on Finance and the Common Good".

Citi's Chief Executive Officer, Michael Corbat, has led and increased our corporate-wide campaign to reinforce Citi's culture of ethics and trust in how we serve stakeholders by building a globally-consistent approach to ethics training and setting global standards for business practices. At every level of the business, we work with our employees to meet and exceed the highest standards of ethical behavior at all times, operating with integrity, honesty and transparency. To instill this value and expectation in the workplace, Citi's CEO and senior leadership frequently reiterate corporate ethics values to employees. In addition, Citi employees receive training workshops, access to an array of resources, and incentives that enable them to act with integrity. At the same time, we encourage our employees to raise concerns if they encounter a task or activity that seems at odds with our values. We have a number of mechanisms that enable Citi employees to report questionable or inappropriate conduct of peers and managers without fear of reprisal.

Our commitment to fostering a culture of ethical decision-making begins with the values outlined in our Code of Conduct, we ask our employees and all those who work on Citi's behalf to meet three tests in making decisions: 1) that they be in the clients' interests; 2) create economic value; and 3) are always systemically responsible. First published in 1997, the Board-approved Code functions as an ethical guide for Citi's global workforce. The Code sets forth the values and principles that direct our conduct when dealing with clients, business colleagues, shareholders, communities and each other. It demonstrates Citi's commitment to a culture of ethics and integrity and applies to all of our corporate directors, officers and employees. The Code is available to the public and published in 26 languages, covering a broad range of topics including: Conflicts of Interest, Fair Employment Practices and Diversity, Safeguarding Personal, Proprietary and Confidential Information, Anti-Money Laundering Compliance, Commitment to Sustainability, Commitment to Human Rights and Responsibility to Raise Ethical Issues. All new employees must acknowledge that they have read, understood and agreed to comply with the Code of Conduct, and we ask that they reaffirm this com-

mitment periodically through mandated trainings conducted on a regular basis.

In addition, individuals performing services for Citi may be subject to comply with the Code by contract or agreement. In 2014, we revised our Code training courses for all employees and non-employees. The Code training course aims to reinforce understanding of our principles, values and standards of professional behavior across our workforce, helping employees become familiar with and act in accordance with Citi's policies and procedures. It also provides an overview of certain key legal and regulatory requirements.

The Code of Conduct is powerful, indispensable in guiding how we conduct our business. It does more than simply establish rules or dictate the behaviors that we expect of our employees. It is equally important to empower employees, support their courage and provide mechanisms that enable them to fulfill those expectations. The Code provides a detailed guide to the structures and processes that Citi has put into place to detect, collect and address incidents that may pose a legal or reputational risk to the bank. As previously mentioned, Citi has procedures and resources available to employees who may encounter potentially unethical situations at work. The Code also outlines those resources and offers specific guidance about how to raise any concerns in a safe and efficient manner with the designated entities within Citi – such as Compliance Officers – that are able to address or escalate those concerns for resolution.

To underscore the importance of and reinforce ethical standards and behaviors, Citi, with the oversight of our Board's Ethics and Culture Committee, developed and championed a company-wide ethics and culture campaign. Launched in 2014, the global initiative included:

- In-person trainings for nearly 5,000 of our most senior managers to foster ethical decision-making and underscore the importance of escalating issues. Citi has recently updated and rolled-out this training to some 40,000 additional senior employees, globally.
- Updates to the internal Citi Ethics Office website, providing employees with easier access to resources, including an ethical decision-making tool, the Code of Conduct, and methods to report concerns.
- A new video series focused on ethics featuring insights and illustrative examples from Citi's senior management team. All employees can access and replay these videos via multiple distribution channels, including internal email and the employee website.

- A Conduct Risk Program to assess and manage the risks associated with any inappropriate conduct of employees and agents that can lead to negative outcomes for consumers, clients, and financial markets.

2. MEETING REGULATORY EXPECTATIONS AND EXTERNAL STAKEHOLDER ENGAGEMENT

We also conduct business in compliance with legal, regulatory and human rights requirements in the countries in which we operate. Upon learning of any investigations regarding our business operations, Citi works cooperatively with local authorities. In the United States, Citi works with the Federal Reserve Board, Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau and Federal Deposit Insurance Corporation to ensure that we comply with established laws and regulations, including Fair Lending and the Community Reinvestment Act (CRA).

In alignment with Citi's commitment to ethical standards, and to exceed increased regulatory obligations and expectations in communities, our commitment extends deep into how we partner with stakeholders and support inclusion and economic progress broadly. Thoughtful engagement with our many stakeholders, including acting on their needs and feedback, is critical to our success. We engage directly with stakeholder groups, including consumers, governments, advocates, employees and others, to ensure that we continue to be of service and refine our services and programs to meet the needs of the marginalized communities and support environmental sustainability.

For example, Citi launched its Sustainable Progress strategy in 2015, a measurable commitment to lend, invest, and facilitate $100 billion in projects that provide environmental solutions, doubling our 2007 commitment to direct $50 billion toward climate-friendly projects – a goal that Citi met 3 years earlier than expected. Citi continues to engage socially-responsible investors regarding its sustainability performance and approach to carbon risk.

To model its commitment to social responsibility and equitable treatment of all people, Citi promotes its global diversity and inclusion policies. It has taken public actions to communicate its support for the extension of civil rights of its LGBT employees in partnership with the Human Rights Campaign and a host of other organizations working to achieve equity and dignity on behalf of the broader community.

In partnership with internal business units and the Citi Foundation, Citi Community Development and Inclusive Finance aim to restore faith and rebuild Citi's reputation in communities. Together, these departments fortify Citi's on-the-ground, institutional commitment to improve the lives of low-income, often vulnerable communities in cities where we operate, leveraging business contributions and philanthropic grants programs to provide greater economic opportunity and enable access to mainstream financial services.

Citi Community Development is a founding member of the Asset Building Policy Network (ABPN), a coalition of the U.S.'s leading civil rights and advocacy organizations committed to improving the economic security, particularly through policy and advocacy to reduce income inequality and racial wealth gap, among racial and ethnic minority households in America. In addition, to promote the integration of eligible immigrants in the US, Citi is the Founding Corporate Partner of Cities for Citizenship, a national campaign with the goal of unlocking the economic asset of attaining citizenship for the nearly 9 million legal permanent residents in the United States. Since launching alongside the mayors of New York City, Chicago and Los Angeles, fifteen additional cities and Miami-Dade County have joined the program.

Most demographic forecasts predict that more than 50 percent of the world's inhabitants will reside in major cities by 2030, and the population of young people will increase by 100 million globally. As an example of Citi's aim to promote economic progress among young people, the Citi Foundation in collaboration with the Economist Intelligence Unit (EIU) launched Accelerating Pathways, the first-of-its-kind index that compares the efforts of 35 global cities to contribute to young people's economic prospects. The project offers a snapshot of young people's ambitions and perceptions of their opportunity as well as factors that contribute to an enabling economic environment for their success. This effort is an extension of the Foundation's Pathways to Progress initiative in the U.S., which works to help urban youth build an entrepreneurial mindset, acquire leadership, financial and workplace skills, and begin to participate in the formal economy through a first job. Policymakers as well as business and civic leaders have the opportunity to use the project's data and findings to formulate and strengthen their policies and programs to include more young people as meaningful contributors to society.

As a global institution with a long-standing history in more than 100 countries, Citi's initiatives move beyond internal campaigns to include

authentic collaborations with community organizations, municipalities, and nonprofits that influence policies to improve the quality of vulnerable people and better position them with the skills, tools, and resources to achieve their goals and aspirations.

3. RESPONSIBLE AND INCLUSIVE FINANCE

A culture of ethics for a global financial institution includes more than just a commitment to discourage, prevent and respond to wrongful activity – it also includes the drive to conduct business that engages positively with society and drives tangible, sustainable impact. At Citi, that commitment comes to life in the leadership role we play in tackling entrenched economic, social and environmental challenges facing cities and communities around the world. As a global bank that operates in some of the most complex urban environments in the world, we understand that the strength and vitality of cities depend on core urban ecosystem needs, such as housing, social services, energy, economic empowerment, financial inclusion and infrastructure. Financial institutions play a critical role in addressing all of these needs, and Citi is committed to investing in systemic efforts that enable urban economic progress for people.

Citi Inclusive Finance is a specialist team that works across Citi businesses globally to develop solutions that enable the bank, its clients and partners to expand access to financial services and advance economic progress in underserved communities. Leading more than 150 commercial partnerships with microfinance institutions in 40 countries, the team represents the broadening of Citi's focus to meet the challenges of affordability, access and resiliency through building a new generation of scalable services, systems and technologies in service of expanding financial access and stimulating economic development. Inclusive Finance goes beyond philanthropy by leveraging cross-sector partnerships and supporting innovative approaches to embed investments that make a social impact into Citi's core businesses to the benefit of clients and communities.

Among many achievements, we arranged the first capital markets transactions for microfinance institutions in a number of countries. We structured the first investment grade bond for microfinance in Mexico with a partial guarantee from the IFC (FT 2004 deal of the year). As the industry and our client's needs have expanded, so have the services and products Citi provides. For example, Citi is pioneering affordable and accessible mobile payments that connect some of the largest companies with

the smallest producers and distributors. In 2014, Citi Inclusive Finance partnered with the IDB to launch a $500 million Education, Youth and Employment (EYE) bond. This first-of-its-kind instrument enables investors to finance programs across Latin America that support early childhood care, primary and secondary education, vocational training and job placement.

Working with the U.S. government's Overseas Private Investment Corporation (OPIC), Citi's decade-plus partnership has provided USD$406 million in direct financing to 44 microfinance institutions in 25 countries to date, funding more than 1.2 million microbusinesses; of which more than a million are owned by women. In 2014, Citi created a new $220 million loan framework that will expand access to financial services for micro- and small businesses in our corporate clients' value chains. Over the life of the partnership, Citi and OPIC have executed 16 different frameworks totaling $2.8 billion in guarantee capacity.

In California, Citi joined with the San Francisco Mayor's Office, the Office of the Treasurer, the Department of Children, Youth, & Their Families and the San Francisco Unified School District to launch Kindergarten to College—the first publicly-funded, universal children's college savings account program in the United States. To date, families have invested more than $1.5 million of their own money into nearly 22,000 savings accounts, which are held at Citibank. Some 50% of contributing families qualify for the National School Lunch Program as they earn less than $40,000 annually for a family of four people. In New York, Citi Inclusive Finance partnered with Grameen America in 2014 to help provide over 7,000 women entrepreneurs in Harlem, New York, with small business loans through 2020. Citi offers savings accounts with no service fees to help women participating in the program build their financial identity and save while Grameen America provides microloans to help grow their businesses. To date, Citi has opened more than 12,000 savings accounts for Grameen members.

4. Conclusion

Every day, Citi strives to meet and exceed our responsibilities to our clients, shareholders, regulators, communities and global partners through strong governance, thoughtful and frequent engagement, and by doing business according to the highest standards of professional and ethical conduct. At Citi we are absolutely convinced that ethics pays. It is exac-

tly what we need to do to provide confidence to the marketplace, to our customers and to our employees, that we are focused on doing the right thing. We strive to act with integrity and to meet and exceed our responsibilities in all that we do. When we don't, we hold ourselves accountable and we expect that our stakeholders will hold us accountable as well. We understand that nurturing a culture that promotes and lives up to a high ethical standard of doing business and engaging with society both strengthens the long-term sustainability of our financial institution and, ultimately, benefits the communities we serve – because without trust, our company and sector cannot succeed.

> Citi's mission is to serve as a trusted partner to our clients by responsibly providing financial services that enable growth and economic progress. Our core activities are safeguarding assets, lending money, making payments and accessing the capital markets on behalf of our clients…
> … These capabilities create an obligation to act responsibly, do everything possible to create the best outcomes, and prudently manage risk. If we fall short, we will take decisive action and learn from our experience.
> We strive to earn and maintain the public's trust by constantly adhering to the highest ethical standards. We ask our colleagues to ensure that their decisions pass three tests: they are in our clients' interests, create economic value, and are always systemically responsible. When we do these things well, we make a positive financial and social impact in the communities we serve and show what a global bank can do.
> Citi's Mission and Value Proposition.

Investing in sustainable finance and social infrastructure – Public Private Partnerships

DOMINGO SUGRANYES BICKEL*

The Centesimus Annus pro Pontifice Foundation was founded by Saint John Paul II in 1993 as a forum for businessmen, professionals, economists and academics that delves into how Christian social teaching can be applied in real economic life. On behalf of the Foundation and its members in 20 countries, I am very honored to have been invited to speak in this highly acclaimed session of the Rome Investment Forum and I would like to congratulate the organisers for putting the emphasis on sustainable and social investment. What do these terms imply?

We urgently need a humanism capable of bringing together the different fields of knowledge, including economics, in the service of a more integral and integrating vision writes Pope Francis in *Laudato si'* (141). And his predecessor in *Caritas in Veritate*: Locating resources, financing, production, consumption and all the other phases in the economic cycle inevitably have moral implications. Thus every economic decision has a moral consequence (37).

When talking about investing in sustainable finance and social infrastructure, the starting point is necessarily an integrating concept of sustainability and social utility, something which is very central to the economic and social views of the Catholic Church and also acceptable for many, whether or not members of the Church.

* Chairman Centesimus Annus pro Pontifice Foundation.

1. NEW SOCIAL DEMANDS OFFER GREAT OPPORTUNITIES

In a way, we are at a lucky point in economic history, in spite of all our uncertainties: the urgent need to rethink existing patterns in economic life can and should be seen as opportunities. We need economic growth to continue fighting poverty, but there is also a 2 demand for qualitative changes: more sustainable use of resources, more responsible consumption, more opportunities for the young unemployed, better professional education, better access to job satisfaction. We are facing a real demand for a qualitatively different economy, and this offers huge opportunities for innovation and investment.

Experience shows that relying on centralized and impersonal public programs does not bring sustainable solutions on either front: qualitative change cannot be achieved through regulation alone; and the old assistance systems can induce a dangerous 'welfare trap' based on passivity and inaction which aggravates poverty.

We know that decentralized entrepreneurial initiative is the only context where the new demands can be satisfied, while the fight against poverty can continue at the same time. If there is demand for more responsible use of resources and more sustainable products, let's go for it: the market economy has given proof of its ability to adapt. The same applies to demands from workers of all ages for better jobs and more job satisfaction.

In order to succeed in satisfying the new demands, entrepreneurial initiative needs a favourable institutional context. Let's admit: there are big obstacles on the way: entitlements which prevent the excluded from accessing jobs; inadequate education systems which lead candidates to unemployment; subsidization which hinders competition, and prevents start-ups to reach break-even; rigid legislations which hinder innovation. We have the moral obligation to be self-critical about our own business practices: too often, we pay lip-service to the market economy while at the same time defend positions of corporatist privilege.

Who are the movers of this necessary rethinking of economic life? Some people would say: the unions, the co-operatives, the new social movements… Maybe, but it won't work unless there is an effective answer in the form of true economic innovation, which in turn is inseparable from

entrepreneurial initiative, intelligently supported – though not controlled – by the State. If there is consensus that environment protection and job creation are today's more urgent needs in Europe, then let's turn to the forces which really have the 3 resources to change the state of things. And this means providing adequate education, regulatory support and available finance to support the flourishing of a new breed of entrepreneurs of the present day.

2. "Help the poor help themselves"

From our viewpoint of the relatively well-off, it is preoccupying to see a growing distance between levels of income. Not so much because of inequality as such – egalitarian utopia don't usually produce good economic or democratic results – but because it seems that in relative terms, and sometimes even in absolute terms, the poor are becoming poorer, even in our affluent society: the problems of wage stagnation or wage reduction, precariousness and marginality. Now the refugee emergency in Europe brings new dimensions to the problem and sometimes can deviate available resources from previously registered poor people. And the usual answer is: more tax.

Is additional tax a solution for these problems? Who guarantees that the new tax revenues would be used for the needs of the poor, when public debt and government uncontrolled expense eat such a large part of public income, and when welfare benefits are still too often spread on people who don't really need them?

In America first, but also in Europe, more and more voluntary philanthropic action is being undertaken by business. This important development requires specific attention. Management expertise, transparency and good governance are great factors of success whereby corporate philanthropy can significantly contribute to social action projects.

On the other hand, business promoted charities need to learn from Church supported and other charitable movements. Social projects can't succeed unless they are based on communities on the recipients' end getting totally involved in decision making and motivation, so as to become dignified agents of their own destiny, using a phrase by Pope Francis in his recent address to the United Nations. Religious and NGOs have an indispensable know-how in organising participative, bottom-up initiatives. 4 Be it religious, idea-

listic, or corporate, philanthropic initiatives are highly positive, but there is need for more: more voluntary involvement by corporations and, above all, more commitment by people and families in the rich parts of the world. We need the funds to become larger so as to reach economies of scale. The amount of resources mobilized needs to be significantly higher if we are to change the trend towards impoverishment. The running of the funds should not only be transparent; their founders should also renounce corporate or local pride and embark more decidedly on the purpose of the common good: and this probably requires joining resources in creating common funds, putting them under independent management and applying to them generally accepted accountability rules.

A focused action on promoting new, professionnally managed voluntary solidarity funds can be an answer to the danger of increased marginalisation. This is a subject on which the Centesimus Annus pro Pontifice Foundation is now working and we hope to come up with action oriented recommendations in the near future.

3. A ROLE FOR SOLIDARITY IN BUSINESS DECISIONS

But what about business itself: is there space for solidarity in business decisions? Investing in Sustainable Finance and Social Infrastructure, our theme of this morning, implies that business decisions involve a degree of solidarity, the same way as in every human act, gift and fraternity coexist with the natural yearning for individual satisfaction.

Against many situations of mismanagement, corruption and lack of accountability – which are now so frequently exposed to public scrutiny – we all know that it is also possible to build areas of the market economy which serve directly the common good. How can we enlarge this bright side of the economy? Let me just indicate a few practical possibilities:

1. Promoting *a culture of service to society* in our organizations is something where we all can invest. Putting organizations to the service of common good is in the first place a cultural fact which in the best cases permeates all policies, 5 from product design to the use of resources, from sales policies to personnel management and financial plans. Why not expressly change our order of priorities, not as a marketing tool, but as a potent management resource?

2. To foster these ideas, we need to *promote intermediate bodies* which autonomously sustain solidarity and contribute to harmonize concepts and interests that would otherwise be in conflict. It is not just Public Private Partnership, as in the title of the present session. The idea is to look for opportunities of developing civil society, i.e. initiatives which are really developed in common between different groups and organisations; for example, social development projects jointly supported by business, associations and public bodies.
3. Linking entitlements with duties allows to *build co-responsibility* at corporate level and in all possible "alliances for change". One of the difficult pre-conditions here is to return to more proportionate levels of rewards between different levels of responsbility, i.e. reducing excessively high salaries and bonuses. This is not totally unrealistic: Let me just quote John Cryan, Deutsche Bank new co-CEO in a recent speech in Frankfurt: "Bonuses don't make bankers work harder… Pay in the sector is still too high, and I don't fully empathise with people who say they turn up to work and work harder because they can be paid a little bit more" (FT, nov 25, 2015).
4. Corporations and small business firms are all indispensable partners of *professional training and transitional monitoring*, which works very well in some European countries, but is totally unsatisfactory in others.

If we are able to communicate these kind of ideas and take the right action in our own professional environment, a favourable climate will naturally emerge for investment in sustainable finance and social infrastructure.

Public-private partnership is not an easy path, unless it is seen in such an integrating framework of corporate culture and active civil society. Why is it difficult? Because we have had so many bad examples of politically influenced mismanagement in finance, in real estate 6 development, in construction and in many more areas of business. On the contrary, long term, sustainable business continuity and success are made of autonomous investment decisions and marketing policies, not on relying on State subsidies or concessions. So a word of caution is necessary about public-private partnership: it might be necessary in the broader context of "alliances for change", but it can work only if all parties are inspired by a vocation of public service, under a strict regime of transparency, well known rules of the game, and total accountability.

4. FINANCE WITH A PURPOSE

Sustainable finance requires a chapter of its own. In the present context of profound changes in the financial sector, both through added regulation and through internally promoted ethical displicine, there is an urgent need for the reforms to be instilled with real ethical and human perspective.

Financial institutions need to redefine their business model in the new context, which probably implies more moderate return targets, a shift towards long term incentives and bonus policies at all levels, and zero tolerance of unethical practice which should always be punitively expensive for those involved. The added regulatory constraints and market demands are in any case forcing the institutions to pay even more attention to consumer protection, to family financial education and to avoid excessive leveraging.

Perhaps in addition to all this, the deepest challenge is to rediscover finance with a purpose: helping job creation through decentralized lending at the level of small firms and local initiative; mobilize financial technology for inclusive finance through the use of mobile devices and digitization: these are just some of the objectives which the best financial institutions are already adopting among their basic policy aims and this is probably the way towards real financial reform.

To conclude: thank you for opening your debate to the theme of this essential rethinking of economic life. In the eyes of the Centesimus Annus pro Pontifice Foundation these questions and challenges do not limit the possibilities of future growth. On the contrary, they are the key which motivates us to look forward and design a future which considers deep changes in both purpose and practice in finance, enterprise and the economy. These are ideas which contribute in the continous exercise to identify the best investment opportunities towards Financing Long-Term Europe.

Micro- and Macro- approaches to ethical recapitalization of the financial sector

PAOLO GARONNA

1. INTRODUCTION

In response to the financial crisis, and beyond, a new awareness has emerged on the importance of ethics in finance. Specific and highly publicised cases of fraud and ethical misconduct have profoundly damaged the reputation of the financial sector. Moreover, the perception has gained traction that widespread opportunism and sloppy integrity standards encourage reckless risk taking and corrupt the overall business climate in the financial world. The outcome has been loss of confidence and poor public trust in finance, which in turn has undermined business opportunities, alienated the sympathy of policy makers and the public opinion. Ultimately this state of affair widened the gap between potential and actual financial activity in terms for instance of intermediation of savings, bank deposits, insurance penetration, and investment opportunities.

The industry response however has been robust energetic and with encouraging results. Ethical reconstruction is figuring prominently in business strategies and communication campaigns. Moreover, it appears "internally-driven", i.e. originating from and building upon the business plans of the financial players themselves. Robert Annibale's paper, of Citigroup *Internally-Driven Ethical Reconstruction: is It Happening?* – which I would like to comment upon – provides a clear illustration of the level of commitment and the variety of tools and programs that the leading enterprises in the trade have devoted to rebuilding trust, strengthening reputation and showing responsiveness to clients' needs and communities' welfare. The paper is highly informative and draws on concrete examples of corporate engagement in ethical reconstruction, aimed at consolidating public confidence and the credibility of the financial industry.

The questions we may wish to ask in relation to these actions and efforts are the following: a) Do these efforts match requirements?; b) Are they enough, and/or necessary?; c) Do they achieve expected goals and outcomes?

In the *Dublin Memorandum*, issued by the Centesimus Annus Pro Pontifice Foundation in 2014, it is rightly stated that "to build ethics into finance, the proper place to begin is the corporation…". Annibale's paper provides a convincing case in support of this statement, showing how the market itself stimulates innovation and social engagement driven by a highly competitive environment. "But – the Memorandum adds – these efforts should combine" with efforts at different levels, i.e. the private with the public, the micro- with the macro- etc.

This "combination" however is not a trivial affair, does not come by itself. It is in the blending of efforts from individual enterprises, government policies, regulators, business and industrial leaders and civil society organizations that lies the secret of success. Furthermore, in moving from the perspective of the individual corporation to that of society as a whole, there may occur a "fallacy of composition" – as economists call it. In other terms, it may happen that what is optimal from the standpoint of the individual corporation may not be optimal from the perspective of the economy and society as a whole. A well-known example to illustrate this concept is in the combination of a micro-prudential with a macro-prudential approach. From the perspective of an individual enterprise, and an individual regulator, increasing the number and the pervasiveness of controls and regulations should lead to greater safety and stability. But if the burden of rules and checks is increased for the whole industry, particularly following a countercyclical pattern, the impact on risk taking and the balance sheet of the sector may become negative and have a devastating effect, leading therefore not to more, but rather less stability and safety. Does this concept apply also to ethical rebuilding?

I will proceed as follows:

- First I will establish a few conceptual foundations, reviewing the notion of ethical capital, and linking it with uncertainty and solidarity.
- Second I will make reference to the global risk scenario and the challenges the financial sector has to address to rebuild public trust.
- I will then review the lessons learned at the corporate level and the best practise, drawing basically on the Citygroup experience.

- I will deal then with the issue of bridging the profitability gap through ethical investment, as an illustration of a possible fallacy of composition.
- Finally I will draw conclusions, focusing on the need for a global strategy, the importance of an industry-level dimension, and on putting "finance for the poor" at the top of the agenda.

I have been inspired and guided throughout by the Catholic social and economic thinking, and in particular, by the encyclical *Caritas in Veritate*, which shifts the focus from the "ethical limits" of finance to its "ethical foundations". In so doing, it gives a further and more profound meaning to the "internally-driven" ethical reconstruction:

> *Efforts are needed – and it is essential to say this – not only to create "ethical" sectors or segments of the economy or the world of finance, but to ensure that the whole economy – the whole of finance – is ethical, not merely by virtue of an external label, but by its respect for requirements intrinsic to its very nature.*
> (*Caritas in Veritate*, par. 45)

2. Conceptual foundations: trust, uncertainty and solidarity

In the economic literature, the notion of trust as capital is a fairly recent acquisition, and presents still several elusive features (Acs 2015, Bull et alii 2010, also Shandwick, Spickard). I cannot in this paper dwell much on such features, but wish only to highlight a few elements of the framework that are required by the arguments developed in the paper.

a) Trust is an economic factor of production (social capital).
b) Trust was undoubtedly hit by the crisis of 2007-2013, but it has been eroded well before the crisis, and will not recover therefore automatically after the crisis. In other terms, there are both "cycles" of trust, and long-term "trends" of trust.
c) Trust is not a raw material, but a renewable source of capital. In other terms, it is both an input, and an output. Therefore, it can – and should – be produced and accumulated through investment and dedicated resources.
d) Lack of trust is inherently linked to uncertainty (F.Knight). Enhancing public trust implies creating a social order through (formal and

informal) rules, but also values and ethics. Norms guide behaviour and make it predictable and meaningful. Ethical capital therefore is part of social capital, a fundamental part of it.

e) Trust is inherently linked to love. Solidarity and social cohesion create an environment that stimulates public trust (see Nussbaum 2013). Even when and where one is confronted with the mysteries of life and the universe, we need not fall prey of fear and anguish. Generosity and the reasons of the heart, supported by faith, should come to rescue leading to trust (emotional capital). On this fundamental link, Catholic thinking has provided in my view its more specific and unique contribution (in *Laudato si'*, there is a whole section on "Civic and political love"). "Social love is the way to authentic development" (*Laudato si'*, par. 228).

In sum, ethical reconstruction should be seen as a very complex comprehensive and resource-intensive endeavour. It belongs to the "core" investment strategies of an economy, or an enterprise, more than to its "external" relations and communications campaign. It must start then from an in-depth understanding of the sources of fear and insecurity that are at the root of public mistrust; and strive to fill the gaps as much as possible with information knowledge and wisdom. Finally, it requires the commitment and engagement that match the challenges to address, i.e. the deployment of a strong sense of responsibility, solidarity and moral leadership.

3. THE PREVAILING UNCERTAINTY OF THE GLOBAL RISK SCENARIO

We live in a world of unprecedented uncertainty. Daunting challenges confront us: terrorism and conflicts, massive waves of refugees and migrants, population aging and climate change, growing inequalities and social fractures, etc. The paradox is that the same forces that create new promises of prosperity and social progress are also at the root of disequilibrium and insecurity. Unprecedented longevity, globalisation, technological change, growing mobility, undeniable progress in education and in fighting poverty illness and hunger, new peoples and players emerging in the global economy: all factors that should open the way to a better future, but that feed instead anxiety and fear. The fact is that we have not been able to manage and steer the push towards change in a way that enables it to bring about its full potential benefit, and at the same time minimizes its costs and negative implications. The ordinary citizens therefore have rea-

sons to be concerned. Inadequate global governance, economic and financial instability, growing deprivation and social vulnerability, the slowdown in output and productivity growth, the frightening solitude and alienation of many new urban landscapes.

These are only a few examples of the many problems that we have been unable to understand and address effectively, and that have led to crisis after crisis. Actually, among the many competing interpretations of the Great Crisis, the one I consider the most encompassing and convincing is the following: before the crisis, we were overconfident of our ability to cope with the global risk scenario, but then in the depths of the crisis we discovered that there are many thinks we do not know, e.g. about systemic interdependence or market clearing or democratic governance, and our institutional mechanisms proved inadequate to cope with the challenges. As we recover from the crisis, we are getting a better understanding of how the economy, finance and policies interact, and we are adopting the necessary institutional reforms.

Rebuilding trust implies coming to terms with this big and global picture. It is the first building block of ethical reconstruction. And it is huge.

4. FINANCIAL DEVELOPMENT: MORE SOLUTION THAN CAUSE OF THE PROBLEM

This line of reasoning helps explaining why the financial sector appears more exposed to the threat of mistrust than other sectors. It is not simply that the crisis started in finance, that there were more fraud and scandals there, or that financial firms were not sufficiently aware and did not invest in it. The real reason is that finance deals with risk and uncertainty, is more reliant on trust than other business sectors, and requires therefore higher levels of integrity, human capital and education.

It is not surprising therefore to see that in the post crisis recovery financial development has come to be considered as a major driver of growth. Financial development and innovation is needed to channel funds towards infrastructure and SMEs, relaunch investment, provide new forms of protection vis-à-vis old age or climate change, support technical change and start-ups.

Finance is called upon to bring uncertainty under control by identifying measuring and managing risks. This requires a leap forward in knowledge and leadership. It is not "irrational exuberance" or "depression" that drives the ups and downs of financial markets, but rather their real and legitimate concern over our ability to understand and manage the challenges ahead.

A proof *a contrario* is in the success of the "whatever it takes" approach that the ECB has been using in steering monetary policy against deflation and instability. Markets regain confidence when they see that leaders are on top of things, and do not shy away from taking responsibility. If we had similar statements coming for instance from the European Council or the G20, in relation to the Syrian conflict or the migration tsunami, among others, the impact on public confidence would be formidable.

5. BUILD ETHICS FROM BELOW: LESSONS FROM THE CORPORATE SECTOR

Individual firms, i.e. banks, insurance companies, pension funds, stockbrokers, financial advisors, etc., have been at the forefront of the battle for regaining the confidence of savers and the public. Corporate social responsibility, responsible investment, sustainable insurance and social impact investment have become new competitive tools in an increasingly competitive market. Competition has stimulated the dissemination of best practise and pushed operators towards investing more and better in business ethics. Branding has come into play as a tool for strengthening the image of social responsibility and the corporate identity of the firm as a caring institution.

Regulators have plaid a fundamental role particularly in the field of corporate governance, compliance, auditing and risk management. However, more than top down prescriptions, what is driving change is the pervasive contagion of best practise and leading by examples.

Internal "codes of conduct", particularly when built with employee-management cooperation, have been effective in producing ownership of the philosophy of good behaviour and an entrenched culture of integrity. They have to be monitored and supported by training, incentives and recognition mechanisms. A focus on "substantive compliance" is needed, capable of going well beyond the formal rules and the avoidance of legislative sanctions. People should feel responsibility for striving for the highest standards of integrity and business ethics.

The question of compensation particularly that of the top management has attracted a lot of attention, sometimes driven by populist campaigns. The issue however cannot be dismissed with a purely defensive response. It is true that adopting the "market rates" of remuneration and avoiding intrusive legislation is necessary to attract the best human capital and encourage "meritocracy". But responsibility should be exercised and excesses avoided.

In order to build ethics from below, the power of good examples and sound leadership is fundamental. Here lies one of the great strengths of the Catholic world and of the teaching of the Church. There is a great tradition, a tradition that is ancient prestigious and spread out all over the world, a tradition nurtured by exemplary cases of excellent work, like e.g. the cooperative movement or the Catholic missions in the developing countries.

Not enough in my view has been done so far for collecting analysing and making available the wide and growing experience of good practise in the field of responsible investment and sustainable finance. It is a question of information, data, case studies, but also of indicators, analytical and benchmarking tools. We need to better understand how ethical capital works, what motivates to invest in ethical capital, what are the obstacles and the constraints, what the returns, the impact and the outcomes.

A fully-fledged *monitoring mechanism* producing on a continuing and regular basis evidence, studies and policy analysis would be highly beneficial. Experience has to be gathered accumulated exchanged and compared, and a better assessment of progress made, or lack thereof, should be made.

6. FROM MICRO- TO MACRO- ETHICAL RECONSTRUCTION: THE QUESTION OF PROFITABILITY

If one considers an individual case of corporate ethical reconstruction, one may think it implies less focus on profitability. To reinforce ethical standards and behaviour at the firm level is not a free lunch. It involves considerable resources. In short, "ethics costs"! The question then is: "Does ethics pay"? or better "Should ethics always pay?". In Annibale's paper, we find a strong statement on this point: "At Citi we are absolutely convinced that ethics pays". Perhaps we should qualify: even though this may not happen necessarily in all cases, in the short term, nor always, it is true that *in the long term, and looking at the generality of the cases*, ethics pays. It is undeniable in fact that many of the channels through which an increase in confidence generates returns that more than offset the increase in costs, do not necessarily operate at the level of an individual company, and in the short term. There are externalities, both negative (because a fraud in one firm reverberates negatively on the whole industry) and positive (because a case of excellence benefits widely the reputation of the sector).

The relationship between ethics and profitability therefore should be analysed more in depth. If we look at the return on equity (ROE) of Euro area banks in the last two decades (Graph 1), we see clearly a sharp fall between 2007 and 2009 that corresponds with the period of the financial crisis and the loss of trust that it entailed. But even before the crisis, and afterwards, the pattern follows a declining trend suggesting that also other factors were at play. Splitting revenues and costs (see Graph 2), we observe that revenues have been on a declining trend throughout the period, and the drop in costs has accelerated after the inception of the crisis, probably in an attempt at sustaining profitability and recovering the erosion of margins.

At the industry level, the question of falling profitability has been, and is of great concern and has been greatly debated and analysed. The squeeze on margins has been attributed to the low interest rates environment, growing competition, and mounting cost pressures. Sluggish demand has also plaid a role and it is likely that consumer and investor confidence has negatively affected demand. However, we are still far from clearly understanding to what extent and how ethical investment, by restoring public confidence and improving customer relations, can have an impact on profitability and invert the declining trend.

I believe that the greatest obstacle to bridging the profitability gaps has be found in the huge financial output gap that prevents the sector from developing at its full potential. Even in the most advanced market economies, we are facing less than optimal levels of banking, low insurance penetration, and insufficient development of capital markets. The gap obviously is much greater in emerging and developing economies. Let us consider for instance the possibility for increasing pension savings and health insurance. Or the need to find new ways of financing infrastructure and SMEs. Or the obstacles that prevent access to equity for startups and young innovators. The emerging new forms of welfare, the growing reliance on public private partnerships to finance investment, the new financial instruments for funding small firms (e.g. minibonds) and social infrastructures, show the potential for enlarging financial markets and making them more profitable, and more able to contribute to the common good. Progress in these endeavours is often linked to advances in knowledge and/or education. On both of them, ethics has a bearing, since public trust is required for fighting uncertainty and promoting solidarity.

It is clear in any case that a fallacy of composition may be operating here. What in fact may take place at the level of an individual corporation

– that might have to sacrifice in the name of ethics short term profits to re-establish its reputation in the market –, does not apply to the entire market. For the economy as a whole, indeed "ethics pays", or at least it should pay! And if it does not, this means that our efforts are not enough, are not well calibrated and coordinated, and therefore are not effective.

7. CONCLUSION: TOWARDS A GLOBAL STRATEGY, MICRO- MACRO- AND MESO-

In commenting on the excellent paper by Robert Annibale, which reflects the leading experience at Citi Bank, I underlined how important are the initiatives developed at the grass-root level by individual players in the financial sector, and more broadly in the business sector and in society. The Dublin Memorandum of the FCCPP pointed out that "to build ethics into finance, the proper place to begin is the corporation". There is a growing body of evidence to substantiate this statement, and much more could be learned if evidence were systematically collected, analysed and disseminated through some monitoring mechanism, which we propose to put in place. Starting from the experience in the Catholic world that should be at the forefront of providing, not only bold thinking, but also, and more importantly practical and concrete examples of good practise and success stories.

However, the Dublin Memorandum rightly adds that "these efforts should combine" with efforts at different levels, the whole of the private sector and the public sector, the stakeholders and civil society. We believe that it is in this "combination" of different initiatives, from regulation to government policies, from business strategies to consumers groups, from opinion leaders to academics etc., that lies the secret of success. We need in other terms an overall "global strategy", comprehensive of all the relevant players, including many different tools and levels, widely shared and consistently supported, a collective and concerted effort within a partnership approach.

In linking the corporate level with the community level, the financial sector can play a critical role that is often neglected. In other terms, between the micro-level and the macro-, a meso-level can be quite important. The finance industry as a whole can and should be perceived as a key player for the common good. A lot can be achieved by the collective efforts of banks insurance companies and funds, without necessarily having recourse to public policies and taxpayers' money. The subsidiarity princi-

ple should be applied here. Leading players in the industry, particularly big corporations, should not only lead in their corporation providing concrete examples of good practise, but they should also exercise leadership in the industry working with other players, especially the smaller ones, in disseminating good practises and encouraging engagement and advancement. In other terms, in the financial sector there should be not only competition, but also cooperation on cross cutting issues, like that of ethics.

A lot remains to be done to convince the public that financial development brings about benefit not only to the firms in the sector but also to the economy as a whole. Showing that a successful model of sustainable development should be finance-driven remains by-and-large still an unaccomplished task (see for an example *a contrario* the report "Where next Europe" by the City of London Corp.). The many ways through which financial development can contribute to the common good should be more clearly spelled out and communicated to the public.

8. FOCUS ON FINANCE FOR THE POOR

On the issue of financial inclusion significant steps forward have been made from the Maya Declaration (2011) to the G20 White Paper on "Global Standard Setting Bodies and Financial Inclusion" (GPFI White Paper 2015).

- First awareness of the importance of the issue has increased at the level of Governments, international organisations (OECD, World Bank, the Basel Committee etc.) and stakeholders' groups.
  Second, we have acquired a better understanding of the risks and benefits of regulation in relation to the goals of promoting the participation of the underprivileged and the underserved in the financial activities. Regulators and standard setting bodies have been at the forefront of this monitoring exercise.
- Third, the analysis of the risks of exclusion has led to several important developments and innovation in the normative framework. For instance, the principle of proportionality and the SME supporting factor have been introduced and supported, due to the concern that an excessive regulatory burden on the weak and small enterprises would have undesirable and unintended negative consequences. A similar preoccupation in relation to underbanked and underprivileged savers and/or investors has led to a focus on inclusive consumer protection. De-risking is another item that has attracted attention, whenever fi-

nancial intermediaries in response to the tightening of prudential norms engage in large-scale termination or restriction of business lines and relationships, affecting poor communities and developing countries.

- The impact of ICT and the very promising prospects of Digital Financial Inclusion have been analysed, particularly the growing role that crowdfunding could play.
- At the practical level interesting and turbulent transformations are taking place at the crossroad of financial innovation and new approaches to financing of social impact investment. New tools, new actors, new organisations are challenging traditional ways of providing support from philanthropy to public services. For a survey, see Salamon 2014.

In spite of these undeniable and significant improvements, the topic remains by-and-large underexplored from the analytical point of view, commitment is lacking and financial inclusion appears to be the "Cinderella" of public policy in the financial sector. This conclusion is endorsed by the White Paper of the G20 on the topic: "*progress on mainstreaming financial inclusion in Standard-Setting Bodies standards and guidance is not enough (…) progress on implementation must also be assessed*" (GPFI White Paper, 2015).

It is undoubted that a leap forward is required in financial inclusion goals and programs. The issue should be put at the top of business strategies and of the policy agenda. Efforts should be made at all levels and from all quarters to give prominence to this objective, and show concrete results. The credibility of our intentions and plans in consolidating ethics in finance is at stake. Financial development should benefit not only banks and the other financial intermediaries, but above all the "real economy" in terms of economic growth and jobs, and especially the most vulnerable segments of the social and economic fabric.

The poor are to be put at the centre of the world of finance.

> *There is little in the way of clear awareness of problems which especially affect the excluded. Yet they are the majority of the planet's population, billions of people. (…) We have to realize that a true ecological approach always becomes a social approach (…) so as to hear* both the cry of the earth and the cry of the poor.
> (Pope Francis, *Laudato si'*, par. 49).

APPENDIX

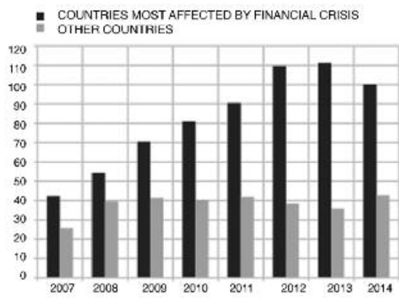
Graph 1

Chart 7

Banks with high non-performing loans have limited buffers against further credit losses

Ratio of non-performing loans to tangible equity and loanloss reserves for euro area significant banking groups

(2007-2014; percentages; median values)



Source: SNL Financial
Notes: Based on publicly avaible data for a sample of significant banking groups. Countries most affected by the financial crisis are Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

Chart 8

Albeit declining, the gap between euro area bank's cost of equity and retur on equity is considerable

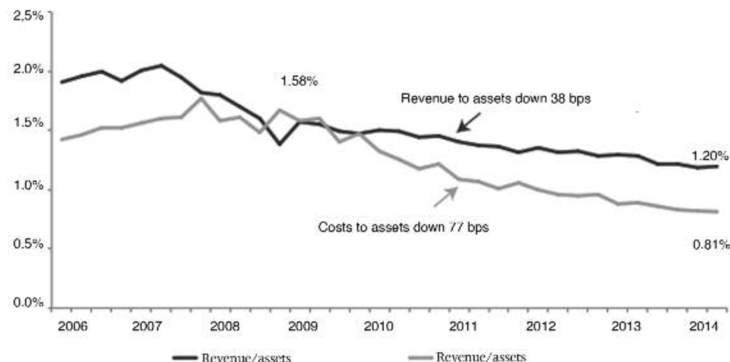
Cost of equity and return on equity for a large sample of listed euro area banks

(Q1 2000 - Q3 2016;percentage points)

Source: Bloomberg, Thomson Reuters Datastream, Consensus Economics and ECB calculations.
Notes: Based on the weighted portfolio of 33 euro area banks in the EURO STOXX index. For further details, see Box 5 in *Financial Stability Review*, ECB, May 2015.

Graph 2

Figure 1: Revenue and costs as a percent of assets
Banks focues on costs, as revenue declined



Financial inclusion

Source Indicator: World Bank.

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