Management and Business Administration Doctoral School

THESES EXTRACT

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Ethical Finances?

A Special View of Ethical Banking and Socially Responsible Investments

Ph.D. Dissertation

Supervisor:

Prof. Sándor Kerekes DSc

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Institute of Environmental Science
Department of Environmental Economics and Technology

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I. Inspiration and Aim of the Topic

The catastrophic events of the last few years, starting in 2008 with the collapse of international financial markets (underlined by the default of Lehman Brothers, one of the oldest, largest and most symbolically significant financial institutions of the world), have sparked much heated public debate. The discussion includes rational and less rational, even demagogic, arguments about the rights and wrongs of the financial industry. In a sense, is the time is now ripe for bringing up the question of ethics, as probably never before have moral issues (maybe with the exception of questions concerning warfare and human rights) become a central point of global discussion.

However, what is completely missing from the discussion is a definition of what essentially is meant by the term 'ethics'. What is ethics? What is right and wrong? From an ethical viewpoint, why have such professions as bankers and traders developed, and why at present are these professions still flourishing despite all their recent difficulties? Based on the information available, are we in the position to judge the actions of the banking system and its beneficiaries – all of us, having any banking relations – as morally right or wrong? If possible, can we set up a metrics of moral behavior to measure the ethical results of actions, and can the result thus derived be used to determine any consequences? Furthermore, who is entitled to create and apply such metrics, and to judge actions of others? And finally, what ethics, what ethical behavior is it possible to discuss in the case of financial institutions and their related parties?

We are almost as much part of the global financial system as we are part of our society. Money and Banking were created out of fundamental human needs. Measurement, storage, and transfer of value is essential for any organized human interactions and no less so the appropriate institutional system which manages it.

Recently, finance and especially banking have become the scapegoat for the present financial crisis. The greed of bankers, the ruthlessness and underhandedness of speculators and investors have all been discussed and harshly condemned. However, in the confusion ensuing from the basic human need to discuss fundamental questions, the whole debate has lost its scope. The desire to want more and better is the driving force

of all of us, and it has created the distribution system known as capitalism, which still provides the best allocation of resources for the broadest number of people. Capitalism, it must be emphasized, is not an ideal, nor even a just and fair system, yet it is still more efficient than any kind of "planned economy", which is neither just nor fair to those subjected to it. If we have any relations to any bank, either as a depositor, or as someone who just simply makes a money transfer or receives loans, we are all the beneficiaries of a relatively liberal economy and financial system. Without financial institutions, banks, bankers, and financial trading activity, we would live at a pre-historical level. (Ferguson, 2008)

In addition, despite all the flaws, smaller deficiencies and systematic problems, banking is still one of the most monitored and regulated activities and industries, regulated in each detail, monitored by state watchdog agencies, by depositors, by media and most importantly by the industry itself. Competitors keep very close watch on each other, following every step and action of their fellow banks. In addition, the institutions themselves have developed strict internal control procedures and methods in order to prevent large-scale frauds, mismanagement or simple negligence. Furthermore, given that risk is inherent in any branch of business but is even more magnified, more rapid in its consequences and more quantifiably measurable in the financial industry, and that the drive to increase expected yield also inherently increases the degree of exposure, the financial industry's internal risk control techniques have reached an extremely sophisticated and sometimes overly complex level. Nevertheless, every system is as only as good as the people running it, and even the most efficient procedures and monitoring is not able to supervise and prevent all misdeeds.

Finding comprehensive works on the topic of finance and ethics was much harder than originally assumed. Though works have been published that deal with the relationship of finance and ethics, these publications tend to be only partial analyses that focus only on particular segments of the issue. In addition, they deal mainly with the question of the financial industry but the definition and especially the explanation of ethics seems to be lacking. In this context, the use of available literature and sources was limited.

The dissertation aim is to try discuss the following hypotheses:

- *In comparison to other industries, due to its relatively transparent and specifically regulated operations, financial industry generally can be regarded as morally sound according the common interpretation of Ethics.*
- *People have to sacrifice their ethical beliefs if they want to invest successfully, or the return on investment will inevitably be lower than traditional investment due to ethical restrictions in the selection process, as suggested by mainstream economic and investment literature.*
- *Financial institutions generally satisfy the operative definition of ethics defined and elaborated within the framework of the present dissertation.*

II. Methodology

There are two distinct methods used in the dissertation in order to reach our conclusion.

- The first was to overview, discuss the most important schools of thoughts in relation to secular Ethics, and then try to derive a potential definition to be used for analyzing moral issues in relation to Economics and Finance.
- While with the second statistical methodology, divided into two different parts:
  - we will try to compare and measure the relevance of moral choices in investment decisions against each other by using so called filtering methods;
  - to compare investment results of different ethics and values, by analyzing the yields of traditional (or non-responsible), responsible investments funds and Islamic funds.

II.1. Overview of relevant Schools of Ethics and Defining Moral

In order to reach a possible definition, we will briefly discuss the most relevant and possibly most important schools of thought within the realm of moral philosophy. Such a process will help us to reach a common understanding in the definition of the ″metrics″ of ethics. The introduction to ethical thought will not be chronologically linear, nor will the order of listing determine the relative ranking of the ideas.

The Schools of Thoughts discussed in the present paper are:

- Deontological Philosophy represented by its greatest thinker Immanuel Kant
- Teleological Philosophy Utilitarian through the works of Bentham and Mill
- Hedonistic Philosophy of Aristotle
- Some of the related Religious Aspects, mainly Protestant Ethics by the works of Max Weber
- A Solidarity based society described by Thomas More

After the introduction into the most relevant Schools of Thoughts in Ethics, the *Definition of the Ethics for Economics is presented.*

Definition of Ethics in Economics: The actions of rational and free human actors in relation to other people as a function of solidarity and scarcity of goods and time.

By the use of the definition, the dissertation will discuss the most important tendencies within the area of Ethical Banking and Investment and also within traditional investment methods.

II.2. Statistical Analysis – Measuring Ethics

The dissertation has an ″ambitious″ goal to attempt to quantify and measure the concept of ethics in finance. The focus of this chapter is to determine if ethics can be measured and, if so, what the consequences are. How much are ethics worth? How much are investors willing to sacrifice for their ethical beliefs if they come with a price tag? Nevertheless, we might find that it is impossible to measure or quantify ethics. In the following analysis, we will examine the result of discretionary investment policy, restrictions or proactive elements above clearly financial considerations, as used in the investment analysis of Socially Responsible Investment Funds (SRI, Socially Responsible Investment). In other words, we are interested in and will try to measure if ethical behavior-induced filters create significant financial results, and if so, then which factors influence them the most substantially. In addition, based on the actual investment policies of SRI asset managers, we will try to pinpoint which are the relevant filters for maximizing both profit and moral considerations, and which ones are redundant or not maximizing ethical ″returns″.

As we have seen in the previous chapter, there is a precise definition of SRI funds, which is widely accepted within the industry. However, for our current analyses, we will assume that any fund can be considered as a SRI fund if its investment policy is not determined solely by traditional investment models but also by other consideration (or filters), which restrict investments in some areas while motivating them in others. We will also see subsequently that restriction and proactive investment management can be regarded as equivalents in our case. According to the views of mainstream economics and finance, any restriction or deviation from the full investment universe is an

irrational behavior. However, as the previous chapters discussed there might be rationality in such an investment policy even if it is lies outside of the traditional investment models.
Based on the previous discussion, the main question about any investment is if the performance of the SRI funds is substantially different from the traditional funds and if there is a discretionary price that investors are willing to pay to invest into seemingly ethical assets. In line with mainstream economic thought, without such investment filters funds can optimize or diversify their portfolio on a larger investment universe and as such they can reach a greater return at the same risk level, or the same return with lower risk. However, as was also shown in the previous chapters, not all research supports the view that ethically driven investment policy necessarily means lower return, and there are rational explanations why yield might be enhanced.

Below, we will examine the question on a micro level, as we will not compare the performance of the SRI funds to traditional benchmark funds, but will analyze the filters themselves to discover their relations. Their very existence and restrictive character will be linked to the result of the funds.

In the first section of our statistical analysis, we will examine the result of discretionary investment policy restrictions (or proactive elements) placed ahead of clearly financial considerations, as is used in investment analysis of Socially Responsible Investment Funds (SRI, Socially Responsible Investment). In other words, we are interested in, and will try to measure*, whether ethical behavior-induced filters create a significant financial result* and if so, than which factors influence them the most substantially. In addition, based on the investment policies of SRI asset managers, we will try to pinpoint, which are the relevant filters for maximizing profit and moral standards, and which restrictions are redundant and/or not capable of maximizing ethical "return".

We will examine the question empirically: by the use of selected statistical methodology applied to a database of SRI funds, the relevance of the influencing factors of a funds' performance are going to be analyzed, especially in case of the determinants of the investment policy.

Based on the findings of the performed analyses (as we would strongly suspect intuitively), we can agree that the investment policy of a fund has a significant influence on its performance. The relative strictness in certain areas or, conversely, the relative laxness of its policy can substantially influence the performance of any fund.
However, it is more interesting that the direction is not necessarily uniform: in certain areas, the restriction increases the expected performance, while in other cases, the lack or neglect of existing filters increases it. The main reason behind the positive result in cases of restrictive policy is most probably the sample period: how these industries or companies performed in this one year. In case of absent or overlooked filters, the investment universe becomes simply larger.

To summarize our microanalyses: ethical behavior by SRI funds has no universal result, in some cases, it can be positive, in some others negative. However, what is important is that if a fund decides to invest based on ethical principles, a good definition of moral values and their translation to the operational level of its investment policy must be appropriately enacted in order to measure its result as well. Even more importantly, what is obvious from the model using the 1-year annual return as its dependent variable is that, independent of the chosen investment policy, the main determinant is the market or more globally the economic environment. In this case, the investment policy is nothing else than the fund manager itself as it is picking its bets.

In the second part of statistical analyses, *Comparative Performance* analyses - the performance of socially responsible investment funds (SRI) and Islamic funds, a.k.a. Sharia-compliant funds, is compared to each other, and to an industry-wide used benchmark (in our case, even more importantly to a traditional non-restrictive fund), i.e. the MSCI World index.

The logic of comparison of SRI and Sharia-compliant funds is that both use certain restrictions (or filters) to limit their investment universe (see the parts of the present dissertation discussing SRI and Islamic finances) and therefore optimize their investments based on non-standard investment analysis criteria. According to the mainstream financial literature, it means that in the long term, the performance of both

sub-segments of the asset management industry is expected to have returns that are either lower at the same risk level or the same higher risk level.

A relatively large database of SRI and Islamic funds results will be compared empirically with the help of statistical methods to each other and to a market benchmark index (MSCI World Index).
As we have discussed earlier, we will work on the basis of empirical data with the help of statistical methods to see if the yield (as the main indicator of the success of a given fund's investment policy) shows any significant difference between various investment sub-segments and a traditional market benchmark. (MSCI Indices, 2012)

To reach a conclusion about the statistical results, it is obvious that no general statement can be made about investment policies, and specifically about filters. Even though both the SRI Funds and the Islamic funds use filters, their results were significantly different in all relevant time intervals and even more importantly, the difference was not always in the same direction. In addition, and probably more interestingly, SRI funds performance always lag behind the traditional funds, while the Islamic funds have always over-performed the market benchmark. Hence, there is no universal claim that can reasonably be made about restrictions or filters with respect to the traditional liberal investment universe, as with certain filters, the funds might over-perform in the market, while with others, they underperform compared to the reference results. The main result of the use of filters is their role in acting as an investment manager. In addition, the examined time periods are also arbitrarily chosen and relatively short, and as such, the results might not be the same for longer time series.

One of the explanations of the above findings is that different industries have different performances (especially during relatively large volatility periods), and – intuitively – the restrictions are not just ethical choices, but also decisions about the investment instruments and as such, they are not neutral in their effect upon the expected result. If a decision/filter made on a purely ethical base happens to prefer industries with good performance (or vice-versa, dislikes poorly performing ones), then the result will be – even by pure chance (i.e. a decision made not according financial factors) – positive.

One interpretation of the statistical analyses of asset managers is theoretical, as filters are nothing else than the fund managers themselves and they are the persons in charge of select the investment tools. However, there is one very serious consequence, independent of how much we choose our investment goals and instruments based on any ethical beliefs: at the end they are investment processes. To form the statement differently and even more counter intuitively, it is completely indifferent how we choose our investments if the selection is based on purely financial reasons or purely on ethical concerns. Furthermore, independent of the selection process, the consequences are the same - either money made or money lost.

III. Findings of the Dissertation

The next section is shortly describing the main findings of the Dissertation, namely: Ethical Banking, Socially Responsible Investments and finally Discussion of the Hypotheses.

III.1. Ethical Banking

The phenomenon of "ethical banking" – and, as a specific alternative, Islamic banking - is described, as it is one of the "hottest topics" in the financial sector now with many arguments both for and against.

What is ethics in finance? Do ethics really exist in finance? Are there socially responsible investments? Given the philosophical, social and moral context, the individual differences of how morality is defined – the general complexity of the question – the length of a dissertation chapter is not sufficient to discuss all the relevant aspects. Nevertheless, this section should try to introduce in brief the concept of ethical banking and to show the major pros and cons. There are two questions, which should be answered if we discuss the issue within the economic context:

- Why are banks, and of course their depositors and shareholders, willing to sacrifice their profit for the "greater" good of the society?
- How much profit are they willing to sacrifice?

These two questions are essentially the same for all ethical finances, including but not exclusive only in case of Ethical Banking, Socially Responsible Investment. In both chapters, we assume that SRI and Ethical Banking are essentially similar, but form two sides of the same coin. In addition, some of the major controversies are going to be discussed in details. Following the discussion of the concept of ethical banking, the section will introduce three financial institutions that have been established and operate solely on their predetermined ethical standards. At the same time, the above-mentioned ˝sacrificed˝ profit and risks involved are going to be presented within the framework of this section.

An ethical bank is a financial institution concerned with the social and environmental impacts of its activities, both on the operational level and, even more importantly, in its banking activity such as lending. Such specialized institutions provide direct finance through lending and risk capital to fulfill the financial needs of selected entrepreneurs, organizations, and businesses. This situation represents a major change in requirements for the banks, as even now banks that operate on the classical paradigm are extensively restricted by institution or industry specific ethical codes. For example, most of the western banks are not only exclude crime-related businesses like drug or trafficking, but explicitly stating that they operate under non-armament policies, or they do not finance clients that intentionally damage nature. The appearance and development of ethical banks require even more from the complete financial sector than the recent self-imposed restrictions. Banks, according the new ethical movement, are required by their owners and depositors to undertake active management of assets, selection of borrowers and determination of investments. In this sense, financial institutions are part of a social change or even part of a paradigm shift toward a more socially and environmentally responsible and activist society. In addition, recently there has been a general distrust towards the banking industry, which also provides opportunity for institutions with an ethical image. These financial intermediaries are willing to accept a lower income or margin during the pursuance of their goals to a more ethical world.

In the same chapter, by a different ethical system but also morally induced financial solution is introduced. *Islamic banking* is considered to be financial activity consistent with the regulation and essence of Islamic law a.k.a. Sharia. In addition, it is obliged through its practice and process to contribute to the development of Islamic economics. Sharia strictly forbids the use of certain interest, specifically riba, to be charged on credit given for the use of money. To provide loans or invest into any economic activity, which are not fully in line with Islamic values and/or unlawful is forbidden too and it is called the Haraam. (Ligeti, 2007)

The strictness of using the Islamic regulation and the ways of interpreting these principles, vary greatly across time and according to each society. In this section, shortly a relatively new phenomenon, the so-called Islamic Banking will be discussed briefly, concentrating mainly on the most important assumptions and solutions. The term

Islamic Banking covers not only classical banking activity conducted according to Sharia but also specific investment and leasing activity. Additionally, the example of Islamic banking supports our earlier argument that ethical banking and socially responsible investment are essentially the same.

III.2. Socially Responsible Investments

Within the same context as Ethical Banking was introduced, we discuss socially responsible investments (SRI) and – as this sector is the most transparent and developed niche of the field of ethical finances –several research and their conclusions will be examined. We will focus on the Asset Management sector. The specific attention to this point is the outcome of its much more intensive documentation in comparison to other types of investment areas.

In investment analysis, several approaches are used for evaluating business potential; therefore providing a general definition of socially responsible investments is difficult but unavoidable. While to certain investors this type of investment means not investing into companies that manufacture certain products (for example cigarettes or alcohol), for other investors who also view themselves as socially responsible the same company may be acceptable.

One of the widely accepted definitions for the activities of fund managements is the following:

- a fund management company/fund has to have a clearly stated socially responsible business policy, and a defined investment policy within this policy
- the fund management company has to inform the market about the socially responsible business policy and this has to appear in writing;
- the fund has to use a so-called cut-off limit that maximizes the ratio of the doubtful investments to ten percent;
- the fund management company needs to have the appropriate systems (legal, technical, human resources) in order to be able to monitor their investments from a social/ethical point of view (Lundberg, Novak, & Vikman, 2009)

This definition gives the minimum criteria of the ethical investments for institutional investors.

According to the supporters of socially responsible, environmentally conscious investments, the analyzing criteria presented previously throw light on such reasons for the economic performance of companies that are not necessarily conspicuous but influence them over the long term. Critics say, however, that every approach that limits the available investment universe will decrease yield or increase risk. The main purpose of the present chapter has been to outline the main factors of the phenomenon called Socially Responsible Investment. Just as in any other case, when individual subjective judgment is involved, there exists most probably a broad range of many different answers. From a clearly financial point, the socially responsible investments do not create any extra value, as they do not add much to the short-term bottom line, to profit. However, we should not forget – and the recent crisis has also encouraged the debate on this question – that there are many factors which cannot be incorporated into one number either on the micro (such as the profit numbers) or on the macro level (e.g.: GDP growth). Based on the above circumstances, it is hard to answer the original question, if the alternative methods of finance based on ethical aspects require a large amount of sacrifice from the ethically driven investors, and if so, how much. Given the relatively short history of the ethical finance movement, it requires more research, a longer time-frame, and more innovation to be analyzed by the researchers. Nevertheless, the final test of viability lies in the very own clients of the ethical banking institutions. At present, there is no doubt that there is a demand for the services of value-driven banks and investment funds, yet only time will decide if this segment of financial enterprises will create enough profit for its investors to keep them alive and prosperous. In addition, only time will prove if they really provide a sufficient long-term utility for the whole society to classify them as ethical financial institutions.

III.3. Evaluating the Hypotheses

In this section, we need to revisit the hypotheses drawn up earlier and with the help of the Ethics definition a common understanding and an answer is derived.

The idea of the dissertation topic emerged from the recognition that morally appropriate business conduct is not a vague idea existing only in the dreams of some rather extreme minds but a rather practical, everyday concern. Furthermore, with the right application in the long term and given the right circumstances, it is a form of conduct that will be profitable. However, there is no reason to be completely naïve: long-term is not a business concept in the fight for everyday survival and the right circumstances are a quite obscure concept. Nevertheless, the right circumstances can be created and it is an obligation of the political system and of us as the voters. We are all part of the economic system, we are all users of the banks and the banking system, and as such, it is our obligation not to fall for populism or for the promise of free lunch (e.g.: excessive interest paid to us on our deposits).

At the beginning of the paper, a few questions were formulated and a definition of ethics has been created. The definition was as follow: ˝The actions of rational and free human actors as a function of solidarity and scarcity of factors of production, goods and time.˝ Until this point, we have analyzed the questions and issues within their conceptual framework and no definition of ethics was invoked. The final chapter is not only a brief summary of the ideas previously discussed but also an evaluation of the main concepts based on the definition of ethics and according to the original hypotheses.

To conclude the Dissertation, in reality, within our everyday life ethical behavior is not something final, it is never concluded, and it does not exist retrospectively but only in the present specific acts. Retrospective evaluation of past actions is useless, as their label in the present is completely irrelevant in respect to the current actions. Furthermore, no individual entity (either natural or legal) can be claimed as ethical or unethical, but their actions alone have moral value. Preparation of the act, the decision, the act itself, and the evaluation of the act is almost a simultaneous dynamic process, a continuous flow. It happens persistently and in most instances there is no possibility to separate the particular segments of the process, since these segments regularly merge and happen at the same time.

The same concept is true in the case of economics and economic entities, specifically the financial industry and for the individual financial institutions, as they are inevitably part of everyday human life and these social institutions are created and operated by people. Moral questions are raised in every moment and no ad-hoc solution will ever satisfy them. Neither single-minded excessive regulation of the financial institutions, nor exaggerated restrictions of the depositors, lenders, or investors will lead to an optimal state. Without a global approach, involving each segment of the globalized world economy, the definition of ethics, though a matter of basic shared understanding, is non-existent.

On the micro level, as everything is decided by the individuals operating and using the constituents of the system, personal responsibility in relation to our own ethical system is fundamental. Apart from the responsibility forced by the society and by derived from regulations, we are all responsible for our actions and we must intend to act according our highest ethical standards.

Before labeling the actions of private institutions, we should keep in mind that their sole obligation is toward their owners and in case they deal with moral questions out of the scope of their regular business practices and primary responsibility - loyalty to their owners measured by long-term profit- they become unethical. We have to trust the people, or in our case more specifically the consumer, to be mature enough to make decisions with the appropriate responsibility. In addition, if we accept that people are mature, they cannot be deprived of the right to choose. In this context, as a division of labor, everybody deals with the issues most relevant for them and there is no need to delegate unnecessary issues to companies, which are also ill-suited and unprepared to address them. There is no reason why the employees of any given company could evaluate moral questions better (apart from their normal course of business in which they are the experts) than any of us.

Nevertheless, and probably even more importantly than any other arguments (also prevalent in the works of Aristotle, the Utilitarian philosophers and Kant, independently of how they differently define morality), ethics is a practical concept, which has to be exercised everyday in each and every moment of our activities in life.

As a note it is important to remark and it was one of the main factors, which also contributed to my choice of topic is that, despite the presentday debate on the topic finding comprehensive works on the topic of finance and ethics was much harder than originally assumed. Though works have been published that deal with the relationship of finance and ethics, these publications tend to be only partial analyses that focus only on particular segments of the issue. In addition, they deal mainly with the question of the financial industry but the definition and especially the explanation of ethics seems to be lacking. In this context, the use of available literature and sources was limited.

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