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Financial Risks – Macroethical Problems and Tasks

There are mainly two obstacles to an adequate ethics of financial risks. First, the standard moral theories have great difficulties with justifying convincing criteria for acceptable risks. We still do not possess a suitable ethics of risks. Secondly, hitherto, the focus of financial ethics has been mainly on questions concerning the micro- and meso-level of economic interactions. I would like to call such an approach a microethical approach. Microethics is concerned with the normative analysis of actions in their individual contexts.[1] Financial microethics tries to establish the moral obligations and responsibilities of individuals working in financial institutions and acting on financial markets. In my view such an analysis is not sufficient. Economic or financial microethics has to be integrated into an economic or financial macroethics. From a macroethical perspective, economic ethics is concerned with the assessment of the fundamental tasks, of the systemic structures and interrelations of the economy, and the evaluation of existing regulations. Furthermore, macroethics analyzes the feasibility or need for the implementation of further measures of governance concerning the economy as a whole. As the most recent financial crisis has shown, a vast number of people not directly involved in financial markets can be massively affected in their well-being by the possible disastrous outcomes of financial transactions, even if the actors on the financial markets are not involved in manipulative, deceptive or fraudulent actions. The prudential and not distinctively immoral actions of many individual actors can easily lead to a collective disaster and endanger the system as a whole. And this is a systemic and thus macroethical problem. Thus, an ethics of financial risks has to be, first and foremost, a macroethics of financial risks.

But it will be impossible to develop such a macroethics of financial risks if we do not know what the principles of an ethics of risk are. Thus, I will first give, from the perspective of a rights-based moral theory, an outline of the main principles of an ethics of risks and the main criteria of acceptable risks.[2]

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[1] For an important contribution to financial microethics see John R. Boatright, Ethics in Finance, Second Edition, Malden: Blackwell, 2008.

[2] This outline summarizes some of the arguments and results of Klaus Steigleder, Risk and Rights: Toward a Rights-Based Risk Ethics. Working Paper, December 2012.

I.

By *risk* I mean the real or realistic *possibility* of a negative event or harm the occurrence of which is not certain or expectable but only more or less likely. However, the probability that harm will occur does not have to be known or be subject to exact numerical specification. Thus, I do not use the term „risk“ as an antonym to „uncertainty“, as is customary in decision theory, but rather as a generic concept that covers both „risk in a narrower sense“ and „uncertainty“. This is because we frequently lack a sufficient basis to determine the probabilities with any precision. In particular, the basic normative questions of an ethics of risk concern both risks in the narrower sense and uncertainties.

Let us assume that we possess moral claim rights to the necessary preconditions of successful agency such as life or health to mention just the most basic preconditions. Rights are justified claims. They reveal certain interpersonal normative relations: There is a bearer of the right, an object of the right, and one or more addressees of the right. The right is an entitlement that the bearer has towards the addressees. A strict duty on part of the addressees is corresponding to the right. Thus, the addressees have a strict duty at least not to interfere with the objects of the rights. So, if I have a moral claim right to life against you, you have a corresponding strict moral duty at least not to interfere with it. I call the infringement of someone's rights morally relevant harms.

Now, to impose the risk of morally relevant harms on someone, e.g. to expose a person to a toxin, the exposure to which could trigger severe illness, cannot be permitted per se. For such endangerment opens up or heightens the possibility that the respective person's entitlement not to harmed will be infringed on by someone who, due to the person's rights, has the duty not to infringe the person's rights. Thus, the endangerment, and hence the risk imposition, affects the right not to be harmed in morally relevant ways. Therefore, viewed only from the perspective of affected persons, a person's right to not be harmed by others in morally relevant ways *implies* the right not to be exposed by others to risks of morally relevant harms. This is even the case if it may turn out that the presumed risks are only putative risks and that there never existed a real danger. What matters is what a reasonable person has to assume when assessing a danger, and not what an omniscient person would assume.

At the same time, however, actually harmful actions are not quite the same as actions that only have an endangering effect or are linked with the risk of harm. For this reason alone we cannot simply infer from a right not to be harmed in morally relevant ways to an *unqualified* right not to be exposed to the risk of morally relevant harms. Moreover,

there are indications of normatively relevant differences. In contrast to direct actual infringements of other person's rights, it might be difficult or even impossible to avoid the exposure of other persons to risks. Thus, a general right not to be exposed in any way or under any circumstances to the risk of harm would entail severe restrictions concerning the actions of those obligated to respect such a right. These restrictions could conceivably infringe upon their own rights in turn. Accordingly, we should be ready to accept that there might be justifiable reasons for actions that expose persons to dangers regarding the objects of their rights.

These considerations suggest that there are two principles of risk ethics. The first principle is:

Every person has a right not to be exposed to risks of relevant harm without sufficient reasons.

The second principle of risk ethics is:

Every person has, within certain limits, a right to perform actions that impose risks on others or that may be linked with risks for others.

While the first principle can be regarded as justified by the foregoing argument on condition that persons have rights not to be harmed by others, this is not the case for the second principle. The second principle implies that a general prohibition of all risk impositions for the purpose of protecting the *affected* parties would inappropriately restrict and hence infringe on the rights of *agents*. This is characteristic of risks and a core subject of risk ethics. In standard theories of rights the restrictions of actions that are justified by the rights of others usually are not in danger of restricting the rights of agents in an unacceptable way. Rather, they are part of the mutual restrictions justified by rights through which, following Immanuel Kant, the same maximum scope of action is provided for any person with the capacity to act. Yet the case is not so clear with actions associated with risks, that is, actions that may only *possibly* harm the affected parties. In such cases the restrictions of the agent's freedom may be *disproportional*. And with that, the rights of the affected parties would receive priority over the rights of agents, which infringes on the fundamental equality of rights between agents and affected parties. Since those who are affected parties in certain situations and contexts can be the agents in other situations, this inequality of rights can also be translated into the Kantian image of the room of maneuver. To be sure, consistent prioritizing of the rights of persons affected by risk-laden actions would establish equal, but not equally maximal rights of agents. Their respective scopes of action, which can have their legitimate

boundaries only in others' equal scopes of action, would be inappropriately restricted. Therefore, agents should be permitted to impose risks on others whenever a prohibition of the corresponding risk-laden action would inappropriately restrict their own rights. They have a right to impose the risk.

Based on the two principles of risk ethics, we need to distinguish between two fundamental types of risk from a moral point of view: 1. Risks of which it has to be assumed that a general *permission* of actions associated with them would inappropriately restrict the rights of *those affected* by the actions. 2. Risks of which it has to be assumed that a general prohibition of actions associated with them would inappropriately restrict the rights of *agents*. I suggest that we call these two types of risks *risks to well-being* or *W-risks* and *risks to freedom* or *F-risks*, respectively. In the case of W-risks, a general permission would inappropriately impair the well-being of the affected parties and their corresponding rights. Therefore, it is generally prohibited to take these risks. In the case of F-risks a general prohibition would inappropriately impair the freedom of agents and their corresponding rights. Therefore, it is generally permitted to take these risks.

As we are interested in the criteria for acceptable risks we must be able, first, to distinguish between F-risks and W-risks and, secondly, to indicate which are the sufficient reasons for imposing W-risks on others. Here I can only give a rough outline.

I will start with the demarcation between F-risks and W-risks. All risks which are not F-risks are W-risks. Thus, first of all, we must concentrate on the criteria for F-risks. As already said, the fundamental characteristic of an F-risk is, that its prohibition would disproportionally restrict the freedom of the agent. There are two kinds of F-risks. For the first kind of F-risks, such disproportion will be given if two conditions are fulfilled. First, in case of a prohibition, a merely possible harm of the affected parties would be matched by an actual restriction of the agent's possibilities to act. Additionally, as a rule it can be assumed that the risk normally will not materialize, at least if the agent takes the necessary precautions. Secondly, the harms which may result from the risk impositions are reasonable for the affected parties. Such reasonableness will be given, (a) if the harm as such is slight and transient, or (b) if the harm is relatively slight and transient – relative to the restrictions the agent had to take on in order to bar the possibility of harming others, or (c) if the harm can be (almost) completely compensated for, should it occur. Such an almost complete compensation will only be possible in relation to impairments of property and not of persons.

As for the second kind of F-risks, these are risks which consist in the possibility of severe harms (such as death or lasting severe impairments) of single persons. But these risks are controllable by the agent to the extent that he or she may be sufficiently certain that the risk will not materialize. If the agent takes the necessary precautionary measures, he or she has in principle a right to the actions which are connected with the risks in question. An admittedly controversial example for such a F-risk is the accident risk connected with driving a car. But, unfortunately, I do not have the time to discuss this example now.

As already said, all risks which are not F-risks are W-risks. It is morally prohibited to impose W-risks on other persons, unless there is a sufficiently justifying reason to do so. There are at least three such reasons: (1.) consent, (2.) the situative priority of rights, (3.) the normative inevitabilty of W-risks. Here, I will only comment on this last reason. Risks can be normatively acceptable if taking them contributes to the prevention of greater risks, and if actions connected with risks are the only means of preventing these greater risks. In particular, it is a justifying reason to impose W-risks on others, if these actions are an essential, normal or natural part of a framework of actions. This framework needs to fulfill the condition that all affected parties may reasonably expect that it will avert greater or higher risks from them or will overall better protect or secure their rights. However, as all collectively benefit from the framework of action which is connected with risks, but the risks only and unequally materialize for single persons, the community (the society) must function as an insurance, which offers help in case of the materialization of risks. Such guarantees help to avoid existential insecurity and thereby secure the rights of the affected persons.

The fact that the inhabitants of the industrialized countries are largely protected from the dangers of nature, that they predominantly have sufficient food, safe, stable and warm housing at their disposal, that they are able to store their food in a cool place, to warm it up etc., is owed to the development and employment of diverse technologies, technical systems and certain forms of social and economic organization. These technologies, systems and forms of organizations are linked with W-risks, but they contribute to protect the affected persons from greater or higher risks and to better secure their rights overall.

Some kinds of W-risks deserve special attention and are especially pertinent for a macroethics of financial risks. These are cumulative, systemic and catastrophic risks. It

is a characteristic of cumulative and systemic risks, that they make overarching national and international regulations necessary.

So, what are the consequences of the general principles and norms of a rights-based risk ethics for the ethics, and especially the macroethics of financial risks?

II.

One consequence of the argument so far is this: at the level of individual persons engaged in trade relations with one another, financial risks represent no moral problem of major priority. Whenever risks are voluntarily accepted by the trading parties, the consensus requirement will apply. However, free and informed consent has to be ensured. An uninvolved third party who has suffered financial loss can, under certain circumstances, be compensated for that loss. According to the compensation requirement, however, a third party may be exposed to financial risks only if the responsible agents are indeed able to compensate the affected parties for any damage done to them, and if it has been ensured that compensation for the damage will in fact be made by the responsible agents.

Even so, within certain limits the financial market is subject to the requirement of normative inevitability of W-risks. By "*the* financial market" I mean the multitude of financial markets and financial institutions existing in a single closed or open economy. The financial market bears inherent risks and is inevitably linked to risks that lie outside any contractual agreements and to risks that may affect uninvolved third parties. Within certain limits, such risks are justified. This is because the financial market is indispensable for the functioning of a developed market economy. As for these market economies, the requirement of normative inevitability of W-risks also applies. For, under the condition of certain framework requirements, including welfare state measures, there is good reason to assume that market economies are better suited than all other forms of economic systems known to date for contributing to safeguarding and protecting the rights of the members of a society. This contribution consists not least in the possibility of a general and lasting increase of our level of wealth.

Now, I do not want to claim that all risks taken and imposed on others in the context of market transactions are justified; however, I do claim that a market economy is inevitably linked with certain risks that concern us all and yet are unevenly distributed. Thus, a business owner frequently has to take risks that concern not only him- or herself but also employees, vendors, and so on. Industry sectors or production locations can be-

come obsolete. There is a constant risk of unemployment. The inevitable risks and (within certain limits) even their inevitably uneven distribution, however, are justified by the fact that, again on condition of certain framework requirements, a market economy is able to prevent greater risks for everyone involved.

Now, if a market economy is justified by its contribution to the safeguarding and protection of the rights of the members of a society, and if the financial market itself is in turn required for the functioning of a developed market economy, then the W-risks inevitably linked to the financial market are justified as well. This justification of financial market risks that the affected parties do not take on voluntarily, and which consist in possible injuries that the responsible agents will not be able to compensate for, is instrumental and hence conditional. The W-risks associated with the financial market are justified (through the requirement of normative inevitability) *only insofar* as the financial market contributes to the functioning of a market economy and is indispensable for it.

Accordingly, there are two major requirements: (1) The financial market, taken as the total of the financial markets and financial institutions of which it consists, has to be sustainably viable. (2) The financial market has to be efficient, meaning it has to sustainably promote the functionality of the market economy. These two requirements serve as a basis for criteria to assess individual financial markets, financial institutions and financial instruments as well as the W-risks associated with them. The criteria can be classified in three groups or types.

First, the lasting or sustainable functionality of the financial market serves as a standard for assessing the individual financial markets and their rules, the financial institutions and financial instruments. If these interfere with or jeopardize the lasting functionality of the financial market, then they will have to be changed, are not to be launched, or discontinued or prohibited. Systemic risks that jeopardize the financial market on the whole are of special significance. Due to the prominent role of the financial market in a well-functioning market economy, as well as the significance of the latter for the well-being of people, the possibilities of a lasting disruption or even a collaps of the financial market constitute W-risks of catastrophic dimensions. Hence it is important to avoid, reduce or eliminate the corresponding systemic financial market risks as far as possible. These tasks are urgent. Accordingly, the interplay of the various elements and agents in the financial market deserves special attention with regard to the presence of systemic risks. Hence the most important aspect concerning our moral as-

sessment of the developments, measures, instruments and institutions of the financial market is the question how they contribute to systemic financial market risks. Do they promote or multiply systemic financial market risks, or do they reduce or eliminate systemic financial market risks, or are they neutral with regard to systemic financial market risks?

In my argument, the term "*the* financial market" denotes the totality of financial markets within a single national economy. Thus, the term "the financial market" does not refer to the global financial market. Each national economy (or the people living therein) has the same right to a sustainably efficient financial market. This right entails at least a negative duty of states and individual market players (including firms and institutions) to see to it that the financial markets of other national economies do not suffer damage or are disrupted by the workings of their financial markets or by their actions. A global financial market must be evaluated according to the degree to which it fosters or harms the sustainable efficiency of the financial markets of each country. These considerations make up a second group of criteria.

The requirement of the normative inevitability of W-risks is undoubtedly a requirement for the justification of W-risks whose details are rather difficult to discern. It is therefore important to develop subsidiary criteria to help us to apply this requirement in practice. Such a subsidiary criterion leads to a third kind of requirement. Insofar as financial instruments are associated with W-risks, their introduction or use is certainly morally inadmissible if it cannot be proven, or at least made plausible, that the instruments are useful with regard to the economy as a whole. This is only a subsidiary criterion, since the corresponding utility factor constitutes a necessary but not a sufficient condition for the introduction of the respective financial instruments to be morally justified. Instruments that fail to meet this requirement do not qualify in the first place as instruments that could be justified by the requirement of the normative inevitability of risks.

III.

In my opinion the consequences of those principles and criteria for the required governance and regulation of financial markets are far-reaching. This is because the financial system is not in line with the principles. On the contrary, it can be argued that the deregulation of financial markets over the past few decades made financial markets less stable. Overall, risks within financial markets were not reduced; instead, systemic risks

were massively built up in multiple ways. In a manner that pervades the entire financial system, financial risks are frequently not borne by those who take them. The higher profits associated with higher risks are skimmed while the losses are not (fully) assumed and often cannot be assumed in the first place. The inclusion of developing countries in the international financial markets or the global financial market proved to be very disadvantageous for many of these countries, causing them multiple and sometimes massive financial crises. Financial institutions became increasingly relevant and dangerous to the system. Whenever they assess that they are "too big to fail" or "too interconnected to fail", banks have strong incentives to take excessive risks. The financial system has become increasingly self-referential and has grown in an unprecedented manner. The purchase of assets is "leveraged", i.e. financed by credit, to a large extent. While, on the upside, there is the prospect of considerable investor returns and hefty fees collected by the intermediators, on the downside, a build-up of systemic risks may result without any recognizable benefits for the sustainable functioning of the economy. Derivative financial instruments play an important part in the self-referentiality of financial markets and the related build-up of risk on financial markets. While the merit of many derivatives is generally beyond dispute, the more complex and advanced forms of derivative instruments are frequently linked to macroeconomic risks that do not have any comparable macroeconomic benefit.

Though the preceding list of negative aspects is still rather incomplete it should already suffice to make clear that from the point of view of a macroethics of financial markets, a drastic restructuring of the financial system is required. This would amount to a restriction of financial market transactions, a dismantling of financial institutions and a prohibition of certain financial instruments. There is no reason to believe that the financial system is more secure today than it was in 2007 when the financial crisis broke out. In my opinion, the measures proposed so far to regulate financial markets are insufficient.

From the perspective of a macroethics of financial markets, the following principles may guide the necessary transformations and regulations of financial markets. First of all we should try to understand which measures and regulations are really or actually necessary to secure sustainably efficient financial markets that contribute to sustainably well-functioning market economies. We should also implement the imperative of the avoidance of systemic risks. By "really or actually necessary" I refer to those measures which ought to be implemented and enforced even if there is no political will to imple-

ment or enforce them. It is important to understand what ought to be done before one takes into account what impedes its implementation. For this allows to recognize the restrictions and curtailments the political realities require and to work out second-best and third-best (etc.) solutions. It also allows to adjust these solutions as far as possible to what is really necessary and to preserve a critical standard for their evaluation. I propose to call those norms that comprise the real necessities "full-scope norms" and to call those norms that account for the political realities and the lack of will to implement full-scope norms "restricted-scope norms".[3]

It is important to note that full-scope norms are only insofar "ideal" norms as they articulate the regulations necessary to establish sustainably stable financial markets irrespective of their chances of implementation. But they do not represent ideal norms in the sense that they presuppose ideal circumstances or ideal agents. Thus, if full-scope norms were implemented, they would achieve their purpose under the conditions of real markets where agents are guided by real motivations In this regard, I would like to stress two points. First, the aims of the sustainable stability of financial markets and their contribution to the sustainable functionality of a market economy may be achieved in different ways, by the implementation of different regulatory packages. Thus, there may be different bundles of possible full-scope norms, and it may turn out that a certain bundle has more chances of implementation than another one. Secondly, as full-scope norms have to be norms which are in effect under real circumstances, one has to be aware that any regulation of the financial market is in itself risky and can easily have counterproductive effects. These may be the result of strategies of avoidance and circumvention that may be triggered by a regulatory measure. A well-intended attempt at minimizing risks can eventually cause an increase in risks. It is not the case that the difficulties in making appropriate proposals for regulation only arise at the level of restricted-scope norms. The formulation of suitable full-scope norms is already a difficult task.

This leads to a further guiding principle. The content of appropriate regulations cannot be determined independently of their form.[4] Simple prescriptions are *ceteris paribus* preferable to more complex or complicated prescriptions. The aims of regulation should be achieved with as few prescriptions as possible. With regard to the affected institu-

[3] For this distinction see Klaus Steigleder, Ethics and Global Finance, in: Michael Boylan (ed.), The Morality and Global Justice Reader, Boulder, Co.: Westview Press, 2011, 169-184, 177f.

[4] This I have learned from Wolf-Gero Reichert.

tions and agents, the prescriptions should be maximally comprehensive in order to prevent loopholes. The proposal of Anat Admati and Martin Hellwig to require of banks a significantly higher equity ratio than provided for in Basel III and to forgo any risk weighing in this context is an attempt to decisively minimize the systemic risks connected with banks on the one hand and to choose a form of regulation that would be both simple and therefore effective on the other hand.[5]

One of the problems of regulation is what Charles Goodhart has called the "boundary problem".[6] A prescription for banks does not affect non-banks. This is why businesses have incentives to behave as an institution that lies outside the scope of regulation. In return it becomes necessary to define the institution that the prescription pertains to as detailed and as comprehensively as possible. In this way the rules get complicated. Perhaps the problem can be solved as follows. First, one would have to define in which cases an institution represents a financial institution. Secondly, one would have to try to make as many of the regulatory prescriptions legally binding for all financial institutions. For instance, a required minimum equity ratio for banks could be made compulsory as a required minimum equity ratio for all financial institutions. Additionally a small number of categories of financial institutions would have to be worked out which certain characteristic activities are assigned to. To do business as a financial institution would require a license which is associated with the classification into at least one of the categories. An institution would only be allowed to perform the activities characteristic of a certain category if it is licensed as an institution of this category. Specific rules would be binding for each category of institutions.

Regarding the content of regulations, the aim must be to avoid and to reduce systemic risks as far as possible and to allow them only insofar as they are necessary for the sustainable functioning of market economies. An essential contribution to this is the already mentioned increase of the required minimum equity ratio of banks and of financial institutions more generally. Furthermore, more transparency must be achieved at different levels of the financial system. For instance, it must be ensured that the risks a financial institution takes are recorded in its balance sheet. Additionally, the question is to be answered whether the OTC-trade must be restricted and whether those trades

[5] See Anat Admati, Martin Hellwig, The Bankers' New Clothes. What's Wrong with Banking and What to Do about it, Princeton: Princeton University Press, 2013.

[6] Charles Goodhart, „The Boundary Problem in Financial Regulation", National Institute Economic Review 206 (October 2008).

which are allowed must be made more transparent, for instance through disclosure requirements.[7]

Financial transactions have to be designed in such a way that those who incur risks actually bear them and that they are only allowed to incur those risks they are really able to bear. Here I must confine myself to mentioning only one area of application. Among the proposals to make the financial system more stable is the establishment or reestablishment of the separation of investment banks and commercial banks. Against this proposal it is frequently argued that such a separation could not have prevented the financial crisis of 2007, since, after all, Bear Stearns and Lehman Brothers were pure investment banks. But in my view this objection overlooks that the decisive point would not be the separation per se but the different legal form of investment banks such a separation would make possible. For the separation would allow prescribing that investment banks must be organized as partnerships and not as stock corporations. The conversion of the legal form of big investment banks from partnerships into stock corporations, a process completed in the United States at the beginning of the 1990s, has significantly changed the risk behavior of those banks.[8] The partners' liability for the debts of the company leads them to avoid certain risks. Thus, the legal form of a partnership may contribute to the fulfillment of the principle that risks must be borne by those who have taken them.

A further important item is the magnitude and the interconnectedness of financial institutions. Regulatory efforts which try to deal with the problem that institutions are "too big to fail" or "too connected to fail" aim at facilitating the split-up and the liquidation of big financial institutions in the case of a financial crisis. But in my opinion the risks must be minimized and the risk behavior must be changed *ex ante*. Therefore, the magnitude of financial institutions has to be limited and the existing large banks and further financial institutions must be reorganized, split up and scaled down. This might also be a consequence of certain capital requirements in connection with the legal form of a partnership.

Finally, the risk effects of financial instruments have to be checked and controlled. Simone Heinemann has made important suggestions for the evaluation of the risks con-

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[7] For a discussion of these questions see Simone Heinemann, Ethik der Finanzmarktrisiken am Beispiel des Finanzderivatehandels, Doctoral dissertation, Bochum 2013, 230f.

[8] See e.g. Suzanne McGee, Chasing Goldman Sachs, New York: Crown Business, 2010.

nected with financial derivatives.[9] The macroeconomic benefits of the usage of derivative instruments have to be shown and to be balanced with the risks connected with their usage. Heinemann stresses that it is especially pertinent to figure out or to assess whether instruments contribute to the generation of systemic risks. Based on the example of Credit Default Swaps she has highlighted the problem that instruments can be used both to hedge risks and to generate new risks. In such a case, certain usages of an instrument must be prohibited. Heinemann supports the proposal of Eric Posner and Glen Weyl to establish a licensing agency for the approval of (the uses of) derivative instruments.[10]

[9] Simone Heinemann, Ethik der Finanzmarktrisiken, op. cit. chapters 5-8; Simone Heinemann, Financial Derivatives and Responsibilities – How to Deal Ethically with Financial Risk, in: Finance and the Common Good 39,1 (2011), 45-56.

[10] Eric A. Posner; Glen E. Weyl, An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets. John M. Olin Law & Economics Working Paper No. 589 (February 2012).